IN THE

Supreme Court of the United States,

OCTOBER TERM, 1942.

No. 61.

IN THE MATTER OF
THE WESTERN PACIFIC RAILROAD COMPANY,
a corporation,
Debtor.

IRVING TRUST COMPANY, as Substituted Trustee under the General and Refunding Mortgage of The Western Pacific Railroad Company,
Petitioner,

against

CROCKER FIRST NATIONAL BANK OF SAN FRANCISCO and SAMUEL ARMSTRONG, as Trustees under The Western Pacific Railroad Company First Mortgage dated June 26, 1916; FREDERICK H. ECKER, JOHN W. STEDMAN and REEVE SCHLEY, constituting the Institutional Bondholders Committee; WESTERN PACIFIC RAILROAD CORPORATION; THE WESTERN PACIFIC RAILROAD COMPANY; A. C. JAMES CO.; THE RAILROAD CREDIT CORPORATION; and RECONSTRUCTION FINANCE CORPORATION,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR RESPONDENTS CROCKER FIRST NATIONAL BANK OF SAN FRANCISCO AND SAMUEL ARMSTRONG, AS TRUSTEES UNDER THE WESTERN PACIFIC RAILROAD COMPANY FIRST MORTGAGE DATED JUNE 26, 1916.

ORVILLE W. WOOD,
Attorney for Respondents Crocker First National Bank of San Francisco and Samuel Armstrong, as Trustees under The Western Pacific Railroad Company First Mortgage dated June 26, 1916.

ARTHUR A. GAMMELL,
Of Counsel.

Dated, New York, N. Y., October 3, 1942.

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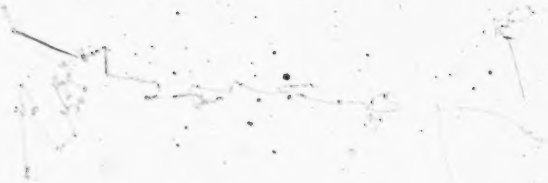

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This is a proceeding instituted by the Refunding Mortgage Trustee to review a decree of the United States Circuit

Court of Appeals for the Ninth Circuit entered on November 28, 1941 (R. 2675), as amended on rehearing by order filed February 12, 1942, as amended by order of February 16, 1942 (R. 2681, 2682), which decree reversed an order of the District Court of the United States for the Northern District of California, Southern Division, entered on August 15, 1940 (R. 1569). The order of the District Court approved a plan of reorganization (hereinafter called the "Commission Plan") for the Debtor, The Western Pacific Railroad Company, which had theretofore been approved and certified to the District Court by the Interstate Commerce Commission (R. 1600), in a proceeding for the reorganization of the Debtor under Section 77 of the Bankruptcy Act, as amended (11 U. S. C. A., § 205).

OPINIONS BELOW.

The Commission's report and order (R. 194, 284) dated October 10, 1938, approving a plan of reorganization for the Debtor, are reported at 230 I. C. C. 61. The Commission's report and order on further consideration (R. 300, 362) dated June 21, 1939, modifying the plan of reorganization approved in the Commission's report and order dated October 10, 1938, are reported at 233 I. C. C. 409. The Commission's report (R. 884) dated September 19, 1939, on which its order (R. 891) dated September 19, 1939, was entered, denying the Debtor's petition for modification of the Commission Plan, is reported at 236 I. C. C. 1.

The opinion of the District Court (R. 1569) dated August 15, 1940, approving the Commission Plan, is reported at 34 F. Supp. 493.

The opinion of the Circuit Court of Appeals (R. 2663) dated November 28, 1941, is reported at 124 F. (2d) 136. No opinion was rendered on rehearing.

JURISDICTION.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A., § 347(a)).

QUESTIONS PRESENTED.

The questions presented are essentially these:

1. Should not this Court, in view of the public interest in bringing about a speedy termination of the reorganization proceedings, decide the issues involved in the so-called "lien controversy", which issues were before the Circuit Court of Appeals but as to which the Circuit Court of Appeals made no specific determination?

2. Were the issues involved in the "lien controversy" correctly determined by the Commission and by the District Court?

With respect to the first question, no controversy exists between the Refunding Mortgage Trustee and the First Mortgage Trustees. In their brief filed in No. 8, the First Mortgage Trustees have taken the position that this Court should decide all of the issues which were before the Circuit Court of Appeals, including the issues involved in the "lien controversy", and should, upon the entire record, reverse the decree of the Circuit Court of Appeals and affirm the order of the District Court approving the Commission Plan.[1]

With respect to the second question, the First Mortgage Trustees believe that the issues involved in the "lien controversy" were correctly determined by the Commission and by the District Court. The argument in this brief will be confined to a discussion of those issues.

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[1] A similar position has been taken by the Institutional Bondholders Committee in its brief filed in No. 7 and by Reconstruction Finance Corporation in its brief filed in No. 33.

STATEMENT OF THE CASE.

A. The "Lien Controversy".

The allocations of new securities under the Commission Plan are premised upon the complete priority of the First Mortgage [1] over the Refunding Mortgage [2] as a lien on substantially all of the Debtor's property, except with respect to certain pledged collateral held by the Refunding Mortgage Trustee (R. 261-267). The correctness of that basic premise is challenged by the Refunding Mortgage Trustee with respect to three classes of property:

(1) The Debtor's equity in certain equipment acquired under three Philadelphia Plan equipment trusts and the so-called Baldwin Lease;

(2) The Northern California Extension; and

(3) Certain so-called "noncarrier" real estate.

A statement of the relevant facts with respect to each of these classes of property will be set forth immediately preceding the portion of the argument to which it relates. This method of presentation, we believe, will facilitate a ready understanding of the questions involved.

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[1] I. C. C. Exhibit No. 5 (R. 1872).

[2] I. C. C. Exhibit No. 6 (R. 1872).

I. C. C. Exhibit Nos. 5 and 6 are among the portions of the record which, by stipulation (R. 2612, 2614), were not printed but which are before this Court pursuant to the stipulation filed July 23, 1942.

The granting clauses of the First Mortgage are printed at R. 1215-1231, as Exhibit D to the Stipulation As To Facts Not In Dispute (R. 1017-1272, 1285)—hereinafter referred to as the "Stipulation" or "Stip." The granting clauses of the Refunding Mortgage are printed at R. 1231-1246, as Exhibit E to the Stipulation. For the convenience of the Court, we have set forth the granting clauses of the First Mortgage in Appendix A of this brief, *infra*, pages 105-115. Page references in this brief to the granting clauses of the First Mortgage are to Appendix A of this brief; page references to other parts of the First Mortgage are to I. C. C. Exhibit No. 5.

Other exhibits which were not printed are referred to in this brief by their exhibit numbers, with citations to the respective pages of the record at which they were offered in evidence.

B. Two Significant Provisions of the First Mortgage.

The answers to the questions involved depend mainly upon the interpretation of the provisions of the First Mortgage.

The provisions chiefly in controversy are the after-acquired property clause in Granting Clause Third [1] and the so-called "free funds" provision.[2] These two provisions fix the boundaries of the lien on after-acquired property. To assist the Court in comparing them, we here set them forth in sequence.

Granting Clause Third.

"*Third.*—Any and all property and facilities of any and every kind and description, including among other things lines of railroad, extensions and branches, telegraph and telephone lines, lines and instrumentalities of water transportation, terminal facilities, equipment, lands, buildings, machinery and tools, stocks, bonds, notes and other obligations and securities and any and all right, title and interest in any of such properties or facilities which may from time to time hereafter be acquired or constructed by or belong to the Company or any successor or purchasing corporation if

(*a*) acquired or constructed by the use of First Mortgage Bonds or proceeds thereof or cash deposited hereunder (except bonds delivered or cash paid out under any of the provisions of this indenture in reimbursement of previous expenditures certified as hereinafter provided) or on account of the purchase, acquisition or construction thereof or work thereon First Mortgage Bonds shall hereafter be authenticated and delivered or the proceeds of First Mortgage Bonds or other cash deposited hereunder shall hereafter be paid out under any of the provisions of this indenture; or

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[1] Appendix A, *infra*, pp. 110-111.

[2] Appendix A, *infra*, pp. 113-114.

(*b*) consisting of or, if securities, representing property or facilities constituting an integral part or parts of lines of railroad, extensions, branches, or other property subject to the lien of this indenture or some other integral portion whereof is or integral portions whereof are subject to the lien hereof or represented by securities subject to the lien hereof; or

(*c*) consisting of or, if securities, representing property or facilities used or acquired for use in or for the maintenance or operation of or appertaining to any of the lines of railroad, extensions, branches or other property subject, or represented by securities subject, to the lien of this indenture; or

(*d*) consisting of shares of stock in or other securities of said The Salt Lake City Union Depot and Railroad Company or said Standard Realty and Development Company or any subsidiary company or any right, title or interest which the Company or any successor or purchasing corporation may hereafter acquire in or to any of the property of either of said companies or in or to any line of railroad or other property of any corporation which shall then be or immediately prior thereto shall have been a subsidiary company, as the term 'subsidiary company' is defined in Section 2 of Article Second hereof."

THE "FREE FUNDS" PROVISION.

"But nothing express or implied in this indenture shall be construed to limit the right or power of the Company or any successor or purchasing corporation, which right and power is hereby expressly reserved, by the use of its credit or free funds or by the use of First Mortgage Bonds delivered to the Company or any successor or purchasing corporation as in this indenture provided to reimburse the Company or any such successor or purchasing corporation for expenditures theretofore actually made out of its free funds, to construct or acquire free from the lien hereof lines of railroad, extensions or branches or interests

therein, equipment, stocks, bonds or other securities or other property, rights, franchises, immunities or privileges provided the same shall not be lines of railroad, extensions, or branches or interests therein, equipment, stocks, bonds or other securities, or other property, rights, franchises, immunities or privileges (*a*) on account of the purchase, acquisition or construction whereof or work whereon First Mortgage Bonds shall be authenticated and delivered or their proceeds or other cash deposited hereunder shall be paid out as herein provided; or (*b*) consisting of, or if securities representing, property or facilities constituting an integral part or parts of lines of railroad, extensions, branches or other property subject to the lien of this indenture or some other integral portion whereof is or integral portions whereof are subject to the lien hereof or represented by securities subject to the lien hereof; or (*c*) consisting of or, if securities, representing property or facilities used or acquired for use in or for the maintenance or operation of or appertaining to any of the lines of railroad, extensions, branches or other property subject, or represented by securities subject, to the lien of this indenture; or (*d*) consisting of shares of stock in or other securities of said The Salt Lake City Union Depot and Railroad Company or said Standard Realty and Development Company or any subsidiary company or of any right, title or interest which the Company or any successor or purchasing corporation may acquire in or to any of the property of either of the companies above named or in or to any line of railroad or other property of any corporation which shall then be or immediately prior thereto shall have been a subsidiary company as the term subsidiary company is defined in Section 2 of Article Second hereof; and the Company may, unless First Mortgage Bonds shall have been authenticated and delivered or their proceeds or other cash deposited hereunder paid out against the same, purchase and acquire equipment, free from the lien hereof, by lease, conditional sale agreement or under any form of equipment trust, or purchase such equipment and issue obligations therefor secured by mortgage or pledge of such equipment superior to the lien of this indenture."

As we interpret these provisions, Granting Clause Third extends the lien to all after-acquired property which falls within any one of the four enumerated categories; the "free funds" provision limits the Debtor's right to acquire property free of the lien to property which does not fall within any one of these same four categories.

SUMMARY OF ARGUMENT.

I. The concept underlying the First Mortgage is that of a mortgage upon a railroad enterprise as an operating entirety.

II. The First Mortgage is a first lien on the Debtor's equity in equipment subject to the Equipment Trusts of 1923, 1924, and 1929, and the Baldwin Lease of 1931.

A. The "exception clause" in the First Mortgage does not have the effect of excepting from the lien equipment acquired under equipment trusts, if such equipment was used or acquired for use on the mortgaged lines.

B. The inclusion in the Refunding Mortgage of language not contained in the First Mortgage does not affect the interpretation of the First Mortgage.

C. The statements contained in the Debtor's listing applications are not binding upon the holders of First Mortgage Bonds.

D. The *Wabash* and *Rock Island* cases, cited by the Refunding Mortgage Trustee, are distinguishable.

E. The First Mortgage covers additions to equipment needed for the efficient operation of the mortgaged enterprise.

III. The Northern California Extension is subject in its entirety to the First Mortgage as a first lien thereon.

A. The granting clauses of the First Mortgage cover in its entirety an extension financed in any part

with First Mortgage Bonds or deposited cash; the lien thus created is not limited, either in extent or priority, to the amount of First Mortgage Bonds or deposited cash used in such financing.

B. The Northern California Extension cannot be divided into bonded and unbonded segments.

C. No supplemental indenture was necessary to entitle the First Mortgage to priority over the Refunding Mortgage on the entire Northern California Extension.

D. The advances by A. C. James Co. and Reconstruction Finance Corporation were not made under such circumstances as to create liens on the Northern California Extension in favor of either.

IV. The First Mortgage is a first lien on the so-called "noncarrier" property.

A. The characterization of property as "noncarrier" property in the Debtor's accounts does not affect the scope of the granting clauses of the First Mortgage.

B. The granting clauses of the First Mortgage expressly cover "noncarrier" real estate owned by the Debtor at the date of the execution and delivery of the First Mortgage.

ARGUMENT.

POINT I.

THE CONCEPT UNDERLYING THE FIRST MORTGAGE IS THAT OF A MORTGAGE UPON A RAILROAD ENTERPRISE AS AN OPERATING ENTIRETY.

The Debtor's First Mortgage, like the Debtor itself, is a child of the 1916 reorganization.

The Western Pacific came out of that reorganization with its entire bonded debt wiped out as debt. Every class of security holders was eliminated except one: holders of old first mortgage bonds received stock in the new holding company, together with the right to purchase new First Mortgage Bonds (R. 1112, 1137, 1143, 1150).

Thus the problem which confronted the draftsman of the new First Mortgage was a simple one. The sole problem was to create a single system first mortgage which would provide the new money immediately needed for the reorganization and which would also provide an adequate vehicle for future financing by the Debtor.

To that end, the draftsman created a first mortgage upon the Debtor's railroad enterprise as an operating entirety.

He provided for the issue under that mortgage of $50,000,000 in principal amount of First Mortgage Bonds. Of these, $20,000,000 in principal amount were to be immediately issued to provide new money for the reorganization (Article Second, Section 1[1]), and the remaining $30,000,000 in principal amount were reserved to finance the making of improvements and to finance the acquisition of new lines of railroad and other properties added to the mortgaged enterprise in the course of its future growth (Article Second, Section 2[2]).

First the draftsman placed under the lien all of the property which the Debtor acquired from its predecessor

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[1] I. C. C. Exhibit No. 5, pp. 37-40.

[2] I. C. C. Exhibit No. 5, pp. 40-44.

(the old Western Pacific Railway Company)—except cash items and except certain claims against The Denver and Rio Grande Railroad Company,—together with all other property owned by the Debtor at the date of the execution and delivery of the First Mortgage, including not merely the right of way and station buildings but also tracts of land which were not at the time being used for the transportation of passengers and freight (Granting Clauses First, Second, Fifth, and Sixth[1]).

He then provided that the lien should attach to all after-acquired property the cost of which should be financed in any part with First Mortgage Bonds or deposited cash, and also to all after-acquired property which should be essentially a part of the mortgaged enterprise (Granting Clauses Third, Fifth, and Sixth[2]).

The draftsman did not limit the lien on after-acquired property to property acquired for use on the Debtor's railroad as it existed in 1916. He extended it as well to new lines of railroad to be acquired in the future (Granting Clause Third[3]), and he provided that the lien should attach not only to the franchises with which the Debtor commenced its operations but also to all after-acquired franchises incidental to the maintenance or operation of the mortgaged enterprise, including new franchises acquired in connection with new lines of railroad thereafter becoming subject to the lien (Granting Clause Fifth[4]).

In order not to hamper the Debtor in financing separate ventures, the draftsman specified (in the "free funds" provision[5]) that the lien should not attach to any new property not essentially a part of the mortgaged enterprise, provided the Debtor finance the acquisition of such property entirely outside of the First Mortgage.

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[1] Appendix A, *infra*, pp. 105-109, 111-113.

[2] Appendix A, *infra*, pp. 110-113.

[3] Appendix A, *infra*, pp. 110-111.

[4] Appendix A, *infra*, pp. 111-113.

[5] Appendix A, *infra*, pp. 113-114.

At the end of the "free funds" provision, the draftsman added the so-called "exception clause",[1] which permits the Debtor to create a first lien security in financing purchases of new equipment under equipment trusts and chattel mortgages, provided the financing be done entirely outside of the First Mortgage.

In order to preserve the integrity of the mortgaged enterprise, the draftsman inserted covenants of the Debtor to maintain its railroad system and property, including its equipment, in good condition and to make all necessary replacements, and also all necessary additions, so that the security of the bondholders might not be depleted by a failure to keep up the operating efficiency of the enterprise (Article Fourth, Section 9[2]).

Throughout the pages of the First Mortgage there appears the concept of a mortgage upon a railroad enterprise as an operating entirety. It is the concept that everything which is essentially a part of that enterprise, or to acquire which any First Mortgage money has been used, shall stand as security for the entire mortgage debt. It is not a concept of undivided interests in separate pieces of property standing as security for separate parts of the debt, but a concept of the enterprise as a whole standing as security for the debt as a whole.

The solution of the interpretation problems raised by the "lien controversy" will be simplified, we believe, if this underlying concept be borne in mind.

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[1] Appendix A, *infra*, p. 114.

[2] I. C. C. Exhibit No. 5, pp. 76-77.

POINT II.

THE FIRST MORTGAGE IS A FIRST LIEN ON THE DEBTOR'S EQUITY IN EQUIPMENT SUBJECT TO THE EQUIPMENT TRUSTS OF 1923, 1924, AND 1929, AND THE BALDWIN LEASE OF 1931.

A. FACTS.

At the date of the execution and delivery of the Refunding Mortgage (March 1, 1932) and at the date of the institution of the Section 77 proceedings (August 2, 1935), equipment trust obligations of the Debtor were outstanding under three Philadelphia Plan equipment trusts (hereinafter called, respectively, the "Equipment Trust of 1923", the "Equipment Trust of 1924", and the "Equipment Trust of 1929"), and the Baldwin Lease of 1931. These equipment trust obligations were of serial maturities, and in each case the agreement provided for a cash payment equal to the difference between the cost of the equipment delivered and the principal amount of the equipment trust certificates (R. 1068-1070).

The initial payments and all payments made by the Debtor on the equipment trust obligations were made with funds other than proceeds of First Mortgage Bonds or deposited cash. Since the institution of the Section 77 proceedings, additional payments on the equipment trust obligations have been made by the Trustees of the Debtor and the Equipment Trusts of 1923 and 1924 have been satisfied (R. 1073-1074).

All of the equipment subject to these three equipment trusts and the Baldwin Lease of 1931 was acquired for use on all of the Debtor's lines of railroad, including those specifically described in the granting clauses of the First Mortgage, and was in fact so used (R. 1975).

An analysis of Exhibit G to the Stipulation (R. 1298)[1] shows the following facts:

[1] This exhibit was not printed.

At the date of the execution and delivery of the First Mortgage, the equipment subject to the lien of the First Mortgage consisted of 1,589 units, which had a book value less accrued depreciation as of that date of $3,550,748.93. Subsequent to the execution and delivery of the First Mortgage, the Debtor acquired by the use of First Mortgage Bonds or deposited cash 5,443 additional units of equipment, which had a book value at the date of acquisition of $11,483,640.21. Thus, the equipment on which the First Mortgage became an undisputed first lien (hereinafter called "Original Equipment") aggregated 7,032 units, of an aggregate book value of $15,034,389.14 (hereinafter called "Original Value of Original Equipment").

As of March 1, 1932, 626 units of Original Equipment, having an Original Value of $690,913.11, had been retired. As of that date, the Debtor had acquired by the use of free funds (not under equipment trusts) 52 units of equipment, having a book value at the date of acquisition of $49,027.16, and had acquired under equipment trusts 3,705 units of equipment, having a book value at the date of acquisition of $13,006,454.87,[1] making a total of 3,757 units, having a book value at the date of acquisition of $13,055,482.03.

As of March 1, 1932, the book value of the Original Equipment then remaining in service, less accrued depreciation to that date, was $9,684,906.77, representing a depreciation in the Original Value of Original Equipment of $5,349,482.37.

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[1] This equipment was acquired under the Equipment Trusts of 1923, 1924, and 1929, and the Baldwin Lease of 1931, and the book value stated above is the total value of the equipment and not merely the value of the Debtor's equity, as is shown by the figures set forth in paragraph 83 of the Stipulation (R. 1068-1070).

B. ARGUMENT.

(I) The "Exception Clause" in the First Mortgage Does Not Have the Effect of Excepting from the Lien Equipment Acquired under Equipment Trusts, if Such Equipment Was Used or Acquired for Use on the Mortgaged Lines.

THE OPPOSING CONTENTIONS AS TO THE INTERPRETATION OF THE "EXCEPTION CLAUSE".

The controversy as to the equipment centers in a single phrase, "free from the lien hereof", appearing in the "exception clause",[1] which is a part of the "free funds" provision in the First Mortgage.

Isolating this phrase from its context, ignoring other significant language in the "exception clause", and giving to the "exception clause" a meaning wholly inconsistent with the general purpose evidenced by the remainder of the "free funds" provision and by the granting clauses as a whole, the Refunding Mortgage Trustee contends that the "exception clause" has the effect of making the Debtor's equity in this equipment entirely free of the lien of the First Mortgage, because this equipment was acquired under equipment trusts and was not financed under the First Mortgage.[2]

But the phrase "free from the lien hereof" cannot be construed in a vacuum.[3]

The equipment in controversy was acquired for use and was actually used on the mortgaged lines—it is essentially a part of the mortgaged enterprise. That being so, it falls

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[1] Appendix A, *infra* p. 114.

[2] Brief of Refunding Mortgage Trustee, pp. 18-32.

[3] "The meaning of a writing may be distorted where undue force is given to single words or phrases. We read the writing as a whole." *Empire Properties Corp.* v. *Manuf'rs T. Co.*, 288 N. Y. 242, 248, 43 N. E. (2d) 25, 28 (N. Y., 1942).

within the after-acquired property clauses of the First Mortgage.

As we interpret the "exception clause", its purpose and effect are merely to enable the Debtor to vest an unencumbered security title in the equipment lienor, whether the financing be done under an equipment trust or under a chattel mortgage. Our contention is that the lien of the First Mortgage attached to the Debtor's equity in this equipment immediately upon its acquisition and spread as that equity was increased by the subsequent installment payments on the equipment trust obligations.[1]

The interpretation problem presented by the "exception clause" will be more readily visualized if the methods of equipment financing ordinarily used by railroads are kept in mind. The Debtor might finance a purchase of new equipment (1) entirely with treasury cash, or (2) with First Mortgage Bonds or deposited cash, or (3) under a chattel mortgage, or (4) under what are known in common parlance as "equipment trusts". The two usual types of equipment trusts are: (a) a lease or conditional sale agreement, under which the legal title to the equipment is reserved in the lessor or vendor until payment of the final installment of the purchase price, and (b) a Philadelphia Plan equipment trust, under which the legal title to the equipment is conveyed to a trustee, which then issues equipment trust certificates for the unpaid balance of the purchase price (an initial down payment in cash being made by the railroad) and leases the equipment to the railroad under a lease which provides that the installments of rental shall be applied to the retirement of the equipment trust certificates and that the legal title to the equipment shall remain in the trustee until all of the equipment trust certificates are retired. Under both types of equipment trusts,

[1] In *United States Mortgage & Trust Co.* v. *Chicago & A. R. Co.*, 40 F. (2d) 386 (C. C. A., 7th Circ., 1930), the court said, at page 392:

> "The lien of the first lien mortgage did not remain suspended until final payment under the lease or equipment obligation, but attached to the interest of the consolidated company as current payments were made out of its general funds, * * *."

the legal title is reserved in the equipment trust lienor as security for the payment of the unpaid balance of the purchase price, and the railroad acquires an "equity" in the equipment by virtue of the initial down payment, which equity increases in amount as successive installments of the purchase price are paid.

Under the first three methods of financing above mentioned, the legal title to the equipment is vested in the Debtor. Under the fourth method, the legal title (which is merely a security title) is vested in the equipment trust lienor.

The interpretation placed upon the "exception clause" by the Refunding Mortgage Trustee leads to this curious result: In the case of equipment financed entirely with treasury cash, and in the case of equipment financed with First Mortgage Bonds or deposited cash, and also in the case of equipment financed under a chattel mortgage—in other words, in every case in which the legal title to the equipment is vested in the Debtor,—the equipment clearly becomes subject to the lien of the First Mortgage, if it be used or acquired for use on the mortgaged lines. In the first two cases mentioned, the First Mortgage attaches to the equipment as a first lien; in the case of equipment financed under a chattel mortgage, the lien of the First Mortgage is subordinated, by virtue of the "exception clause", to the lien of the chattel mortgage. But, in the single case of equipment financed under an equipment trust, in which the legal title to the equipment is vested, not in the Debtor but in the equipment trust lienor, the "exception clause" (so the Refunding Mortgage Trustee contends) has the effect of making the Debtor's equity entirely free of the lien of the First Mortgage.

The General Purpose Evidenced by the Granting Clauses of the First Mortgage.

No rule of construction is more fundamental than that the "writing will be read as a whole, and every part will be interpreted with reference to the whole; and if possible

it will be so interpreted as to give effect to its general purpose."[1]

The general purpose evidenced by the granting clauses of the First Mortgage is expressed in two parallel and complementary provisions.

The first is a provision in Granting Clause Third,[2] which is to the effect that all after-acquired property, including equipment, and including "any and all right, title and interest" in equipment, shall become subject to the lien, provided that such property falls within any one of four specifically enumerated categories (hereinafter for convenience referred to as the "four categories"), viz.:

> (1) Property on account of which First Mortgage Bonds or deposited cash shall have been taken down;
>
> (2) Property constituting an integral part of the mortgaged property;
>
> (3) Property used or acquired for use in or for the maintenance or operation of or appertaining to any of the mortgaged property; and
>
> (4) Securities of and property acquired from certain subsidiary corporations.

The second is the "free funds" provision,[3] which in effect permits the Debtor, by the use of its credit or free funds, to acquire property, including equipment, free of the lien, provided that such property does not fall within any one of these same "four categories".

The language used in Granting Clause Third to define the extent of the after-acquired property clause is substantially identical with the language used in the "free funds" provision (preceding the "exception clause") to define the limitations upon the Debtor's right to acquire property free of the lien. The language used is not con-

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[1] 3 Williston on Contracts (Williston and Thompson Rev. Ed. 1936), p. 1779.

[2] Appendix A, *infra*, pp. 110-111.

[3] Appendix A, *infra*, pp. 113-114.

tradictory; it is complementary. The after-acquired property clause and the "free funds" provision, when placed side by side, fit together like the two parts of an ancient parchment indenture and indicate clearly a general purpose (1) to subject to the lien all after-acquired property, provided that such property falls within any one of the "four categories", and (2) to permit the Debtor, by the use of its credit or free funds, to acquire any property free of the lien, provided that it does not fall within any one of the "four categories".

The Purpose of the "Exception Clause".

The "exception clause" was obviously inserted to meet the requirements of a particular situation of great practical importance—the necessity of permitting the Debtor to finance purchases of equipment through loans secured by liens upon the equipment purchased. To that end, it was essential to empower the Debtor to make effective pledges of the equipment—whether under some form of equipment trust or under some form of chattel mortgage—as security for the advances obtained. There is no reason to believe that the draftsman of the First Mortgage sought to accomplish anything more. To accomplish that result, consistently with the general purpose above stated, it was necessary only to create an exception to the first lien character of the coverage of the First Mortgage, so as to enable the Debtor to vest an unencumbered security title in the equipment lienor. It was not necessary also to prevent the lien of the First Mortgage from attaching to the Debtor's equity in the equipment, and such a result would be inconsistent with the general purpose above stated.

If the equipment in controversy had been acquired by the Debtor entirely by the use of free cash in its treasury, it would unquestionably be subject to the lien of the First Mortgage, because it was acquired for use and was actually used on the mortgaged lines and therefore falls within the third of the "four categories". What reason can there be for making a distinction based on the fact that this equip-

ment was acquired under equipment trusts instead of with treasury cash? It is fair to assume that the draftsman of the First Mortgage was seeking to accomplish an intelligent purpose. But to impute to the draftsman an intent that the lien of the First Mortgage should attach or should not attach to equipment, according to the chance circumstance of whether it is acquired with treasury cash or under an equipment trust, is to impute to the draftsman a whimsical intent which is not consistent with any intelligent purpose.

We submit that the "exception clause" should be given a sensible meaning consistent with the general purpose above stated and that the after-acquired property clause and the "free funds" provision, when read as a whole, have the effect of subjecting the Debtor's equity in this equipment to the lien of the First Mortgage.

Not only does the Refunding Mortgage Trustee lift the "exception clause" out of its context as a part of the "free funds" provision; it does not even construe the "exception clause" itself as a whole.

The "exception clause" deals with two alternative methods of equipment financing, viz., (a) financing under some form of equipment trust, with the legal title vested in the equipment lienor, and (b) financing under a chattel mortgage, with the legal title vested in the Debtor subject to the lien securing the equipment obligations.

We believe the language used in dealing with these two alternative methods of financing shows that the purpose of the "exception clause" is not to free the Debtor's equity from the lien of the First Mortgage but merely to enable the Debtor to vest an unencumbered security title in the equipment lienor. In dealing with financing under an equipment trust, where the legal title is in the equipment lienor, the draftsman used the words "free from the lien hereof". In dealing with financing under a chattel mortgage, where the legal title is in the Debtor, the draftsman used the words "superior to the lien of this indenture". This differentiation in the language used shows that the draftsman was thinking, not of the Debtor's equity

but of the security title. In each case, he used appropriate words to disencumber the security title.

The context clearly shows that, in the case of chattel mortgage financing, the draftsman contemplated that the First Mortgage would be a lien on the Debtor's equity in the equipment. Why should he make a whimsical distinction between equipment financed under a chattel mortgage and equipment financed under an equipment trust? The sensible interpretation, we submit, is that the Debtor's equity is subject to the lien of the First Mortgage in both cases and that the "exception clause" merely disencumbers the security title, thereby enabling the Debtor to create a first lien security for the equipment obligations.

The Function of the Single Limitation in the "Exception Clause".

The "exception clause" places a single limitation upon the right of the Debtor to finance purchases of equipment with first lien equipment obligations, that limitation being expressed in the words "unless First Mortgage Bonds shall have been authenticated and delivered or their proceeds or other cash deposited hereunder paid out against the same".[1]

Relying upon a superficial resemblance of language, the Refunding Mortgage Trustee erroneously assumes that the single limitation in the "exception clause" is identical with the first of the four limitations upon the right of the Debtor to acquire property free of the lien which are specified in the preceding part of the "free funds" provision,[2] and it proceeds to argue that there "would have been no point in repeating" that first limitation in the "exception clause", if it had been intended that all four of the limitations specified in the preceding part of the "free funds"

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[1] Appendix A, *infra*, p. 114.

[2] The "free funds provision" permits the Debtor to acquire property free of the lien, provided that such property does not fall within any one of the "four categories". The "four limitations" referred to in the brief of the Refunding Mortgage Trustee (p. 22) are those expressed in the enumeration of the "four categories".

provision should apply to property acquired under the "exception clause".[1]

The fallacy of this argument lies in its premise. As an analysis will show, the single limitation in the "exception clause" is not identical with the first of the four limitations expressed in the "four categories"; their functions are distinct and independent. The function of the four limitations expressed in the "four categories" is to limit the right of the Debtor to acquire property free of the lien; the function of the single limitation in the "exception clause" is to limit the right of the Debtor to finance purchases of new equipment with first lien equipment obligations.

Nor does the single limitation in the "exception clause" have the effect of preventing the lien of the First Mortgage from attaching to equipment acquired under the "exception clause" and not financed with First Mortgage Bonds or deposited cash. This becomes instantly apparent when the "exception clause" is read as a whole.

The "exception clause", as we have seen, deals with two alternative methods of equipment financing, viz., (a) equipment trust financing, and (b) chattel mortgage financing. The single limitation in the "exception clause" applies equally to both, and it is logical to assume that its effect is the same in both cases.

The words "superior to the lien of this indenture"[2] show that equipment financed under a chattel mortgage may come under the lien, even though no First Mortgage Bonds or deposited cash be used in the financing. The single limitation in the "exception clause" does not have the effect, then, of preventing the lien of the First Mortgage from attaching.

But what is the test of whether, in a particular case, the lien attaches or does not attach to equipment financed under a chattel mortgage? Obviously, that test must be sought outside of the "exception clause". The "exception clause" is not a granting clause. Equipment comes

[1] Brief of Refunding Mortgage Trustee, p. 22.

[2] Appendix A, *infra*, p. 114.

under the lien, not by virtue of the "exception clause" but by virtue of the after-acquired property clauses, which by their terms extend the lien to all property falling within any one of the "four categories". If, as the Refunding Mortgage Trustee contends, the test of the "four categories" does not apply, we are left without any test for determining whether, in a particular case, the lien attaches or does not attach to equipment financed under a chattel mortgage.

Accepting the argument of the Refunding Mortgage Trustee leads to this bizarre result: If the test of the "four categories" does not apply, equipment financed under a chattel mortgage must come under the lien, not by virtue of the after-acquired property clauses but by virtue of the "exception clause" itself, operating as an independent granting clause. Since nothing in the "exception clause" limits the extent of the lien in such a case, it must follow that the lien attaches to all equipment financed under a chattel mortgage, even to equipment used exclusively on unmortgaged lines.

This but shows the morass of logical difficulties into which we are led by the attempt of the Refunding Mortgage Trustee to lift the phrase "free from the lien hereof" out of its context and to construe it in a vacuum without regard to the general purpose evidenced by the granting clauses.

When the "exception clause" and the preceding part of the "free funds" provision are read together as one harmonious whole, the function of the single limitation in the "exception clause" becomes perfectly clear. It prohibits the Debtor from financing purchases of new equipment with first lien equipment obligations, unless the financing be done entirely outside of the First Mortgage.

Whether the lien of the First Mortgage attaches or does not attach to the Debtor's equity in the equipment is determined, not by the "exception clause" but by the test of the "four categories". Under that test, the lien attaches to all equipment used or acquired for use on the mortgaged lines, whether the cost be financed entirely with

treasury cash, or be financed with First Mortgage Bonds or deposited cash or be financed under a chattel mortgage, or be financed under an equipment trust.

This interpretation gives due effect both to the single limitation specified in the "exception clause" and to the four limitations specified in the preceding part of the "free-funds" provision, and it gives a sensible meaning to the "exception clause" which is consistent with the general purpose evidenced by the granting clauses.

The Refunding Mortgage Trustee argues that our interpretation of the "exception clause" would limit the operation of the "exception clause" to "equipment bought for use exclusively on after-acquired branches or extensions not financed with First Mortgage funds and which was never used on the main line" and argues that such a limitation "would be unreasonable, and also contrary to sound railroading practice, for efficient use of equipment requires that it be available for use on any portion of the railroad's property".[1]

A complete answer to this argument is found in Granting Clause Fifth,[2] which in effect provides that the lien shall attach to after-acquired equipment (among the other property) which is "* * * used or held for use as, or as a part or as parts of, or to facilitate or safeguard the maintenance or operation of, any lines of railroad, extensions, branches, * * * or other properties now or at any time hereafter subject to the lien of this indenture—*whether the same exclusively appertain to or be used as parts of or in or for the maintenance or operation of lines of railway or other properties subject to the lien hereof or appertain to or be so used as parts of or in or for the maintenance or operation of such lines of railroad or other properties in common with lines of railroad or property not subject to the lien hereof*".[3]

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[1] Brief of Refunding Mortgage Trustee, pp. 21-22.

[2] Appendix A, *infra*, pp. 111-113.

[3] Italics in this brief are ours, unless otherwise designated, or unless otherwise clearly indicated by the context.

This language evidences a clear intent that the First Mortgage shall become a lien on all after-acquired equipment which is essentially a part of the mortgaged enterprise, even though the Debtor may also use such equipment in connection with wholly separate unmortgaged ventures.

THE "SUBJECT, HOWEVER," CLAUSE.

Although, as we believe, one need not look beyond the provisions already discussed for convincing proof of the correctness of our interpretation of the "exception clause", that interpretation finds added support in the "subject, however," clause,[1] which immediately follows the habendum clause in the First Mortgage. This provision was cited by the Commission in its report dated October 10, 1938 (R. 266). It reads:

> "SUBJECT, HOWEVER, as to all equipment now owned to the equipment trust or conditional sale agreements secured thereon, *and as to equipment hereafter acquired, to the equipment trust or conditional sale agreements to which the same shall be subject as permitted hereby,* and as to any property hereafter acquired by the Company or by any successor or purchasing corporation and becoming subject to the lien of this indenture, to any liens thereon existing at the time of such acquisition and not expressly prohibited by the terms of this indenture."

As the Commission aptly said, "If all equipment acquired under equipment trusts was to be entirely free of the lien of the first mortgage, it is not apparent why the words 'equipment trust or conditional sale agreements to which the same shall be subject as permitted hereby' were made part of the last quoted provision" (R. 266).

The Refunding Mortgage Trustee contends that these words refer to a situation in which the cost of new equipment is financed partly with First Mortgage Bonds or deposited cash and partly under an equipment trust. In such a situation, the Refunding Mortgage Trustee con-

[1] Appendix A, *infra*, p. 115.

tends, the First Mortgage will attach to the Debtor's equity as a lien subordinate to the lien created by the equipment trust.[1]

For a railroad to purchase equipment under an equipment trust and to finance the acquisition of the equity with first mortgage bonds authenticated and delivered against the acquisition of such equity would be so unusual as to be a practically unheard of situation. It is difficult to believe that the draftsman of the First Mortgage inserted the phrase above quoted merely to provide for such a situation. It is logical to suppose that he had in mind situations involving the ordinary methods of equipment trust financing.

In support of its contention, the Refunding Mortgage Trustee refers to the bond and cash takedown provisions in Section 2 of Article Second of the First Mortgage[2] and particularly to the definition of the words "lien" and "charge" in subsection G, on page 60, as indicating that the First Mortgage contemplates that the cost of new equipment may be so financed.

We believe the provisions of the First Mortgage do not permit the cost of new equipment which is being financed in part under an equipment trust to be made the basis for taking down First Mortgage Bonds or deposited cash.

The definition of the words "lien" and "charge", in subsection G, on page 60, is as follows:

> "The words 'lien' and 'charge,' as used in this Section 2, shall be deemed to include, among other things, *deferred instalments of the purchase price of property in every case where title thereto has not then vested in the purchaser* or, having so vested, is subject to a vendor's lien or any right of the seller to retake or enforce a charge upon such property upon default in the payment of such deferred instalments of the purchase price and also *the deferred payments to be made or rentals to be paid under any conditional sale agreement or lease or trust agreement covering equipment.*"

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[1] Brief of Refunding Mortgage Trustee, pp. 23-25.

[2] I. C. C. Exhibit No. 5, pp. 40-60.

The purpose of requiring the Debtor to certify "liens" and "charges" in an application to take down bonds or deposited cash is twofold: (1) to disclose to the First Mortgage Trustees the existence of any encumbrances which might affect the right of the Debtor to bond the property, so as to enable them to determine whether the property can be bonded at all, and (2), if the property is bondable, to show the amount of indebtedness secured by such encumbrances, so that bonds or deposited cash may be reserved against them pursuant to subsection E, on pages 57-58.

The mere fact that a certain kind of encumbrance is included in the definition of the words "lien" or "charge" does not mean, however, that property subject to such an encumbrance may be bonded. The bond and cash takedown provisions specify various conditions precedent to the bonding of property, which must in each case be complied with. Among these conditions precedent is the requirement, in clause (a) of paragraph Sixth, on page 54, that the First Mortgage Trustees shall be furnished with evidence of the execution and delivery to the Debtor of "all deeds, conveyances or other instruments necessary to vest the title to such property" in the Debtor.

The definition of the words "lien" and "charge", on page 60, includes at least one example of an encumbrance the existence of which would prevent the bonding of property, because the requirement that title be vested in the Debtor could not be met. The definition includes "deferred instalments of the purchase price of property in every case where title thereto has not then vested in the purchaser."

Obviously, the term "title", as used in the above-quoted language of the definition, has the same meaning as in clause (a) of paragraph Sixth. Although the term is not defined, the context indicates that it means "legal title". If this be the correct meaning, then equipment acquired under an equipment trust or conditional sale agreement could not be bonded, because the requirement in clause (a) of paragraph Sixth that title be vested in the Debtor could not be met.

If we accept the Refunding Mortgage Trustee's explanation of the "subject, however," clause, we are obliged to draw another illogical distinction between equipment financed under an equipment trust and equipment financed under a chattel mortgage.

In the case of equipment financed under a chattel mortgage, the "exception clause" makes perfectly clear that First Mortgage Bonds or deposited cash may not be used unless the lien of the chattel mortgage be subordinate to the lien of the First Mortgage. Otherwise, the single limitation specified in the "exception clause" becomes meaningless, for the language is,

> "and the Company *may, unless* First Mortgage Bonds shall have been authenticated and delivered or their proceeds or other cash deposited hereunder paid out against the same, * * * purchase such equipment and issue obligations therefor secured by mortgage or pledge of such equipment *superior to the lien of this indenture.*"[1]

Yet, in the case of equipment financed under an equipment trust, the Refunding Mortgage Trustee contends that if First Mortgage Bonds or deposited cash be used in the financing, the lien of the First Mortgage will be subordinate to the lien created by the equipment trust.

To require that the bondholders be given a first lien on the equipment in the one case, but not in the other, would be no less than capricious.

(II) The Inclusion in the Refunding Mortgage of Language Not Contained in the First Mortgage Does Not Affect the Interpretation of the First Mortgage.

The "exception clause" appearing in the Refunding Mortgage[2] contains a proviso to the effect that, when and as the Debtor acquires an equity in equipment acquired under

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[1] Appendix A, *infra*, p. 114.

[2] I. C. C. Exhibit No. 6, pp. 22-23.

equipment trusts or chattel mortgages, such equity shall become subject to the lien of the Refunding Mortgage. The Refunding Mortgage Trustee contends that the absence from the First Mortgage of a similar proviso indicates an intent that the Debtor's equity in equipment acquired under equipment trusts shall be free of the lien of the First Mortgage.[1]

We submit that the interpretation of the provisions of the First Mortgage must be governed exclusively by the terms of that instrument, without reference to the terms of the Refunding Mortgage. We believe that, under the proper interpretation of the granting clauses of the First Mortgage, the Debtor's equity in the equipment subject to the Equipment Trusts of 1923, 1924, and 1929, and the Baldwin Lease of 1931 is subject to the lien of the First Mortgage. We do not perceive how this result can be deemed to be affected by the chance circumstance that the draftsman of a mortgage executed nearly sixteen years after the execution of the First Mortgage considered it appropriate to insert in that instrument additional language not appearing in the First Mortgage. As is well known, during the period since 1916, there has been an increasing tendency on the part of meticulous draftsmen to insert in corporate mortgages language intended to dispose of every conceivable question which might be raised as to their meaning, even though under a reasonable interpretation the meaning would otherwise be clear.

(III) The Statements Contained in the Debtor's Listing Applications Are Not Binding upon the Holders of First Mortgage Bonds.

The Refunding Mortgage Trustee contends that certain language appearing in certain of the Debtor's listing applications, in connection with issues of First Mortgage Bonds, indicates a practical construction of the First Mortgage as not covering the Debtor's equity in the equipment

[1] Brief of Refunding Mortgage Trustee, pp. 19, 22, 25.

subject to the Equipment Trusts of 1923, 1924, and 1929, and the Baldwin Lease of 1931.[1]

The language of the listing applications, however, at most indicates the construction placed upon the First Mortgage by the Debtor, which is the party beneficially affected by such construction. There is nothing in the record to indicate that either the First Mortgage Trustees or the holders of First Mortgage Bonds—the parties adversely affected—acquiesced in such construction. It is difficult to understand how the meaning of a contract can be deemed to be governed by a purely unilateral construction placed upon it by the party beneficially affected, without such construction being acquiesced in by the parties adversely affected.

> "Contemporary construction of a contract by acts of the parties is entitled to very great weight, but it ought to appear with reasonable certainty that they were acts of both parties, done with knowledge, and in view of a purpose at least consistent with that to which they are now sought to be applied." *Kane* v. *Schuylkill Fire Ins. Co.*, 199 Pa. 205, 207, 48 Atl. 989 (Pa., 1901); cited with approval in *Sternbergh* v. *Brock*, 225 Pa. 279, 74 Atl. 166, 169 (Pa., 1909).

To give to the language of the listing applications the effect claimed by the Refunding Mortgage Trustee would amount to adopting the fantastic proposition that the lien of the holders of outstanding bonds can be changed or made to vanish by the mortgagor company inserting a statement in a listing application which the bondholders may never have seen or heard of.

Nor do the cases cited by the Refunding Mortgage Trustee[2] support such a proposition.

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[1] Brief of Refunding Mortgage Trustee, pp. 17, 26-27.

[2] *Continental Co.* v. *United States*, 259 U. S. 156 (1922); *In re New York, N. H. & H. R. Co.*, 27 F. Supp. 392 (D. C., D. Conn., 1938), aff'd on op. below, 104 F. (2d) 1018 (C. C. A., 2nd Circ., 1939); *Cunningham* v. *Pressed Steel Car Co.*, 238 App. Div. 624; 265 N. Y. Supp. 256 (N. Y., 1933); *Continental Ins. Co.* v. *Minneapolis, St. P. & S. S. M. Ry. Co.*, 283 Fed. 276 (D. C., D. Minn., 1922).

Continental Co. v. *United States* involved a controversy between the preferred and common stockholders of the Reading Company as to their respective rights in the distribution of capital assets on liquidation. This Court based its conclusion on the construction of the words of the organization agreement of 1896 and referred to the language of the listing application of 1904 merely as confirming that conclusion.

The Refunding Mortgage Trustee interprets this case as holding that the corporation which filed the listing application was "the representative of the security holders".[1] This interpretation is apparently based upon the language of the first part of the sentence appearing at the bottom of page 180 and the top of page 181 of 259 U. S., only the last part of which is quoted in the brief of the Refunding Mortgage Trustee. We submit that the language does not justify such an interpretation. We quote the full text of the sentence:

> "Coming as this must have come from the *representatives of both* the preferred and common stockholders, it is significant evidence of *what they then thought* of their respective rights and has the additional weight of a representation to future purchasers of the two classes of stock as to the kind of interests they were buying in the company."

The use of the plural "representatives" and the reference to "both" groups of stockholders indicate that the Court was referring, not to the corporation but to individuals having authority to speak for both groups, and the words "what they then thought" indicate that the Court had in mind persons consciously formulating an opinion as to their rights with knowledge of the facts.

If it be argued that the directors of a corporation are the "representatives" of the stockholders, who elected them, it does not follow that either the directors or the corporation are the "representatives" of bondholders, with authority to compromise or destroy their security by

[1] Brief of Refunding Mortgage Trustee, pp. 26-27.

statements made without the knowledge or consent of the bondholders. Even a mortgage trustee is not the "representative" of its bondholders to that extent.

In *Guaranty Trust Co. of New York, et al.* v. *Minneapolis & St. L. R. Co., et al.*, 36 F. (2d) 747 (C. C. A., 8th Circ., 1929), cert. denied, 281 U. S. 756 (1930), the trustee under the Minneapolis & St. Louis First and Refunding Mortgage joined with a successor to the mortgagor company and the trustee under the successor company's mortgage in executing a so-called "closure agreement", the effect of which, if valid, would have been to terminate the operation of the after-acquired property clauses of the Minneapolis & St. Louis First and Refunding Mortgage. The Minneapolis & St. Louis First and Refunding Mortgage bondholders were not parties to the "closure agreement", but it was argued that the mortgage trustee was the "duly accredited representative of the bondholders", and that the bondholders were therefore bound. The Circuit Court of Appeals concurred in the view of the District Court that the mortgage trustee was without such authority (p. 753).

The District Court nevertheless held the "closure agreement" to be binding on the bondholders "upon the ground that there was no sufficient proof in the record that the agreement was entered into without their knowledge; that there was no showing as to the time when the bondholders first learned of the agreement, even if they did not know of it at the time of its execution; that there was no showing whether these bondholders had held their holdings in 1912; and, finally that the recording of this agreement in the various counties in Minnesota, and with the secretary of state of South Dakota, besides other acts of publicity, showed laches on their behalf in asserting the alleged violation of their rights" (p. 754). The Circuit Court of Appeals, in holding that the "closure agreement" was not binding on the bondholders, said (p. 754):

> "The bondholders, in their pleading denied knowledge of the 1912 agreement, but the decision of the lower court, in effect, imputed knowledge to them, apparently on the ground that a reasonably prudent man

should have found out what was shown by the public records, or what was a matter of some notoriety. We are of the view that such an imputation is not warranted. The agreement was made without consulting the bondholders, and without their knowledge; and, until there was a default in the payment of the interest coupons, there was nothing to arouse in any bondholder the least suspicion that the mortgage had been modified by a subsequent agreement."

The *New Haven* case involved a controversy between the trustee under the Air Line Mortgage and the trustee under the New Haven First and Refunding Mortgage as to which mortgage constituted a first lien on certain parcels of land originally acquired by the Air Line Company or its predecessor. The Air Line Mortgage, which purported to cover all of the property of the Air Line Company, was executed in 1905 at the request of the New Haven, at a time when the New Haven was operating the Air Line property as lessee, and the mortgage recited that the Air Line Company had been legally requested to execute a mortgage of all of its property. In 1907, the New Haven acquired all of the Air Line property through a merger. The New Haven First and Refunding Mortgage was not executed until 1920.

The court, after finding in the Air Line Mortgage a plainly expressed intent to cover the parcels of land in question, then went on to state (p. 395) that an examination of the circumstances surrounding the execution of the Air Line Mortgage led to no different conclusion. In that connection, the court referred to a listing application filed by the New Haven in 1908—twelve years before the execution of the New Haven First and Refunding Mortgage—in which the New Haven stated that the Air Line bonds were secured by a mortgage upon all of the property of the Air Line Company. The court overruled an objection of the trustee under the New Haven First and Refunding Mortgage to the introduction of the listing application in evidence.

The listing application, which was filed years before the New Haven First and Refunding Mortgage came into exist-

ence, constituted an admission against interest by the New Haven, the party adversely affected by the interpretation placed by the court upon the language of the Air Line Mortgage. There is nothing in the *New Haven* case to show that a listing application not acquiesced in by bondholders may be used to support an interpretation of the mortgage adverse to the bondholders. The same is true of the *Cunningham* case.

In the *Cunningham* case, a bondholder sued to enforce payment of his bonds after maturity, and the question was whether the unconditional promise to pay at maturity, contained on the face of the bonds, could be contradicted by a reference in the bonds to the indenture, which indenture contained provisions restricting the right of bondholders to sue. The court held that it could not. In the opinion, the court mentioned the fact that the listing application filed by the defendant referred to no provision in the indenture, or otherwise, which would preclude any bondholder from enforcing collection of his bonds at maturity (p. 627 of 238 App. Div.). To the extent that the listing application was given any weight, it constituted an admission against interest by the party adversely affected.

In *Continental Ins. Co.* v. *Minneapolis, St. P. & S. S. M. Ry. Co.*, the plaintiffs, preferred stockholders of the defendant railway company, sought to enjoin the payment of a dividend to holders of common stock, on the ground that the payment would violate their preferential rights as specified in the preferred stock certificates. The court held that the language of the preferred stock certificates was inconsistent with the provisions of the articles of consolidation and that the latter must prevail. The court held that the rights of stockholders established by the articles of consolidation "could not be changed, either by inadvertent or intentional action, by the board of directors" (p. 284).

The court further held that there was no estoppel in favor of the plaintiffs against the defendant and added that there had been a practical construction of the contract with reference to the preferred stock (p. 284). The facts which the court recited as establishing a practical construction showed that the plaintiffs, with knowledge,

acquiesced in a course of conduct by the defendant railway company which negatived the interpretation of the contract for which the plaintiffs were contending.

In the preliminary statement of facts in the first part of the opinion, the court quoted language appearing in two applications made to the New York Stock Exchange for the listing of preferred stock (p. 278), but the court made no mention of the listing applications in its recital of the facts which it regarded as establishing a practical construction (p. 284). Curiously enough, the language of the listing applications supported the interpretation contended for by the plaintiffs rather than the interpretation adopted by the court.

Prior to the filing of the first of the listing applications relied upon by the Refunding Mortgage Trustee, over $27,000,000 in aggregate principal amount of First Mortgage Bonds had been issued (R. 1045-1046). It is absurd to say that the holders of those bonds were bound, at their peril, to ascertain from day to day whether the Debtor was about to file with some stock exchange a listing application containing statements which compromised or destroyed their security and to take steps to prevent such filing.

(IV) The Wabash and Rock Island Cases, Cited by the Refunding Mortgage Trustee, Are Distinguishable.

As authority for its interpretation of the "exception clause", the Refunding Mortgage Trustee places reliance upon an unreported opinion of Judge SANBORN in *The Equitable Trust Company of New York, Trustee* v. *The Wabash Railroad Company, et al.* (R. 1721-1734) and upon an unreported opinion of Judge WILKERSON filed on October 31, 1939, in the Rock Island reorganization proceeding.[1]

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[1] Brief of Refunding Mortgage Trustee, pp. 27-32.

For the convenience of the Court, a copy of Judge WILKERSON's opinion, as it appears at pages 2807-2838 of the Printed Record in the Rock Island reorganization proceeding, is set forth in Appendix B of this brief

A comparison of the granting clauses of the Wabash mortgage and of the two Rock Island mortgages with the granting clauses of the First Mortgage will show that the provisions of the Wabash and Rock Island mortgages differed so radically from the provisions of the First Mortgage that these cases throw little light upon the interpretation of the "exception clause".

Neither the Wabash mortgage *nor the* Rock Island mortgages contained any provision comparable to the "exception clause" in the First Mortgage. The so-called "reservation paragraph" in the Wabash mortgage, which was the provision which Judge SANBORN was construing, was in reality a "free funds" provision. The same is true of the so-called "proviso" in the Rock Island "general gold bond mortgage" and of the so-called "free property clause" in the Rock Island "first and refunding mortgage".

In the *Wabash* case, Judge SANBORN relied upon specific repugnant language in the "reservation paragraph" (or "free funds" provision), coming at the end of the granting clauses, to contradict and cut down the sweeping general language of the after-acquired property clauses.

In the *Rock Island* case, Judge WILKERSON was faced with the problem of reconciling seemingly contradictory language in the granting clauses (including the "free funds" provision) of each of the two Rock Island mortgages. In each case, he considered the effect of particular language in the after-acquired property clauses and in the "free funds" provision as indicating a general purpose and sought to give a meaning to both the after-acquired property clauses and the "free funds" provision which would be consistent with that general purpose.

As we have pointed out, the language of the after-acquired property clauses and the language of the "free-funds" provision in the First Mortgage are not contradictory but complementary and, when read together, clearly indicate an intent to subject to the lien of the First Mortgage the Debtor's equity in the equipment subject to the Equipment Trusts of 1923, 1924, and 1929, and the Baldwin Lease of 1931.

(V) The First Mortgage Covers Additions to Equipment Needed for the Efficient Operation of the Mortgaged Enterprise.

THE COVENANT TO MAINTAIN THE OPERATING EFFICIENCY.

In addition to the grant, in Granting Clause Third, of after-acquired equipment "used or acquired for use in or for the maintenance or operation" of the mortgaged enterprise,[1] and in addition to the grant, in Granting Clause Fifth, of after-acquired equipment "used or held for use * * * to facilitate or safeguard the maintenance or operation" of the mortgaged enterprise,[2] the First Mortgage contains, in Granting Clause Fifth, the following grant of after-acquired equipment (among other property):

> "any and all *replacements*, renewals, improvements and betterments of *and additions* to any such lines of railroad or any property or rights of whatsoever description now or at any time hereafter subject to the lien of this indenture, whensoever and by whomsoever such replacements, renewals, improvements, betterments or additions may be made."[3]

The last quoted after-acquired property clause is supplemented by a covenant of the Debtor, in the first paragraph of Section 9 of Article Fourth,[4] which reads as follows:

> "Section 9.—The Company will diligently preserve all of the rights and franchises to it granted and upon it conferred and will at all times maintain, preserve and keep its railroad system and property in

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[1] Appendix A, *infra*, p. 110.
[2] Appendix A, *infra*, p. 112.
[3] Appendix A, *infra*, p. 113.
[4] I. C. C. Exhibit No. 5, p. 76.
The second paragraph of Section 9 contains a special maintenance and replacement covenant which applies only to equipment upon which the First Mortgage is a first lien. This covenant is quoted and discussed at pages 44-46 of this brief.

good repair, working order and condition and *will from time to time make all needful and proper* repairs, renewals and *replacements and* alterations, *additions*, betterments and improvements; and will cause each subsidiary company to preserve its rights, franchises and property in like manner and to like extent."

This covenant, which requires the Debtor not only to make all needful and proper repairs, renewals, and replacements but also to make all needful and proper "additions", is in effect a covenant of the Debtor to maintain under the First Mortgage a railroad fully equipped for efficient operation and, to that end, to make such "additions" to its equipment and other property as may be necessary to keep up the operating efficiency of the mortgaged enterprise. Coupled with the corresponding language in Granting Clause Fifth, this covenant defines the scope of the grant of after-acquired property as including after-acquired equipment coming within the description of such "additions", and it has the effect of causing the lien to attach to all after-acquired equipment which is needed for the efficient operation of the mortgaged enterprise.

The governing principle was stated by then Chief Judge Cardozo of the New York Court of Appeals in *Guaranty Trust Co.* v. *N. Y. & Q. C. Ry. Co.*, 253 N. Y. 190, 170 N. E. 887 (N. Y., 1930), in the following language (p. 199 of 253 N. Y.):

> "A mortgage of property to be acquired in the future is not a present lien at law (*Rochester Distilling Co.* v. *Rasey*, 142 N. Y. 570). It is, however, equivalent to a covenant to give a lien, and as such, when the property comes into existence, may be specifically enforced in equity (*Kribbs* v. *Alford*, 120 N. Y. 519): *In the absence of intervening equities forbidding such a use, the property, when acquired, is deemed to feed the mortgage, as if in existence at the beginning* (*Holroyd* v. *Marshall*, 10 H. L. Cas. 191; *Zartman* v. *First Nat. Bank*, 189 N. Y. 267). There is need to distinguish, however, between the enforce-

ment of the covenant in respect of property thereafter acquired by the mortgagor itself, and property thereafter acquired by a successor or a purchaser. *Property thereafter acquired by the mortgagor itself will be subject to the mortgage, if within the description of the covenant*, however alien it may be in quality or function to the property presently subjected to the lien (*People's Trust Co.* v. *Schenck*, 195 N. Y. 398; *Ithaca Trust Co.* v. *Ithaca Traction Corp.*, 248 N. Y. 322). It is otherwise in respect of purchasers, and even at times successors. To spread the lien of the mortgage to property acquired by these, there must be an independent ground of duty. This may have its origin in a statute or in a covenant of assumption or in the principles of estoppel or accession, or in some other kindred equity (*Trust Co.* v. *City of Rhinelander*, 182 Fed. Rep. 64, 69; *Metropolitan Trust Co.* v. *Chicago, etc., R. R. Co.*, 253 Fed. Rep. 868; certiorari denied, 248 U. S. 586)."

There can be no question but that the equipment acquired under the Equipment Trusts of 1923, 1924, and 1929, and the Baldwin Lease of 1931 was needed for the efficient operation of the mortgaged enterprise. The fact that this equipment was acquired for use and was actually used on the mortgaged lines, and the fact that the Debtor's management deemed the acquisition of this equipment to be so essential as to justify a resort to borrowing, sufficiently evidence the need. This equipment therefore is "within the description of the covenant".

At the time this equipment was acquired, there were no "intervening equities" to prevent the lien of the First Mortgage from attaching. The Refunding Mortgage had not come into existence, and, in any case, the holders of Refunding Mortgage Bonds could not establish superior equities with respect to this equipment. In view of the subordination provision in the Refunding Mortgage,[1] the holders of Refunding Mortgage Bonds could have no standing in equity to claim a prior lien on property coming

[1] I. C. C. Exhibit No. 6, p. 23.

"within the description of the covenant" in the First Mortgage and which the Debtor was under an equitable duty to subject to the lien of the First Mortgage.

See *Westinghouse Electric & Mfg. Co.* v. *Brooklyn R. T. Co.*, 276 Fed. 152 (D. C., S. D. N. Y., 1921).

As will be observed, the covenant in the first paragraph of Section 9 of Article Fourth is more than a mere covenant to replace specific units of equipment as they are retired from service: it is a covenant to make all needful and proper "additions". Moreover, the "description of the covenant" is not confined to equipment on which the First Mortgage is a first lien: it is broad enough to include equipment acquired under equipment trusts. Nor is there anything in the language of the covenant, or in the corresponding language in Granting Clause Fifth, to suggest that a marking of the equipment is a condition precedent to the attaching of the lien.

Regardless of the interpretation placed upon the "exception clause", we submit that the First Mortgage is a first lien on the Debtor's equity in all of the equipment in controversy, because this equipment constitutes "additions" needed for the efficient operation of the mortgaged enterprise.

The Doctrine of the Minneapolis & St. Louis Case.

As applied to equipment, the covenant in the first paragraph of Section 9 of Article Fourth is a threefold covenant: it is a covenant (1) to maintain in good condition, (2) to make replacements, and (3) to make "additions".

In *Guaranty Trust Co. of New York, et al.* v. *Minneapolis & St. L. R. Co., et al.*, 36 F. (2d) 747 (C. C. A., 8th Circ., 1929), cert. denied, 281 U. S. 756 (1930), the Circuit Court of Appeals for the Eighth Circuit considered the effect of maintenance and replacement provisions of a railroad mortgage as causing the lien of the mortgage to attach to equipment which would otherwise be free of the lien.

In that case, the Iowa Central First Mortgage contained maintenance and replacement provisions in the following language (p. 756):

> "The trustee shall also have power to allow the mortgagor, its successors or assigns from time to time to dispose, according to its or their discretion, of such portion of the equipment, machinery and implements at any time held or acquired for the use of the said railways as may have become unfit for such use, replacing the same by new, which shall at once be subject to the lien of these presents without any further conveyance or mortgage. * * *" (eighth paragraph).
>
> "The mortgagor shall and will until the bonds secured by this indenture are fully paid, make all necessary repairs and replacements to keep up the property, rolling stock and equipment hereby conveyed and transferred, * * *." (fourteenth paragraph).

As will be observed, the fourteenth paragraph of the Iowa Central First Mortgage contained a maintenance and replacement covenant substantially similar to the maintenance and replacement covenant in the first paragraph of Section 9 of Article Fourth of the First Mortgage, but it contained no covenant comparable to the covenant to make "additions" which appears in the first paragraph of Section 9 of Article Fourth of the First Mortgage.

After holding that the granting clauses of the Iowa Central First Mortgage did not cover after-acquired equipment, the court said (p. 757):

> "The mortgage does, however, contain replacement clauses, and under these it was the duty of the mortgagor and its successors to maintain and replace the mortgaged equipment. Under this covenant the mortgagor, and its successors, were required to keep under the lien of this mortgage *the same value amount of equipment as it existed at the time of the execution of the mortgage.* In other words, the lien of this mortgage attached to all equipment owned by the Iowa Central at the time of its execution, and so much of the equipment thereafter acquired, either by itself or its

successors, *as was necessary to keep intact in value the equipment as it existed at the date of the execution of the mortgage.* * * *"*

In other words, the court construed the limited maintenance and replacement provisions of the Iowa Central First Mortgage as requiring the mortgagor company to maintain under the mortgage equipment of a value equal to the original value of all mortgaged equipment. The principle applied was the maintenance of the original value of the mortgaged equipment and not the replacement of specific units of equipment which had been worn out or destroyed.

The doctrine of the *Minneapolis & St. Louis* case was applied by Judge WILKERSON in his recent opinion in the Rock Island reorganization proceedings, which is set forth in Appendix B of this brief, although Judge WILKERSON did not cite the *Minneapolis & St. Louis* case. That Judge WILKERSON applied the same principle, namely, the maintenance of the original value of the mortgaged equipment, is apparent from the formula which he prescribed, which is set forth at pages 142-144 of Appendix B.

Applying the doctrine of the *Minneapolis & St. Louis* case to the facts of the present case, and giving effect only to that portion of the covenant in the first paragraph of Section 9 of Article Fourth which requires the Debtor to maintain in good condition and to make replacements, would lead to the conclusion that, prior to the execution and delivery of the Refunding Mortgage on March 1, 1932, the lien of the First Mortgage had already attached to the Debtor's equity in substantially all of the equipment in controversy.

The Original Value of Original Equipment was $15,034,389.14.[1]

On March 1, 1932, the depreciated book value of the Original Equipment then remaining in service was $9,684,906.77. At the date of the execution and delivery of the Refunding Mortgage, therefore, the Debtor was required, under the doctrine of the *Minneapolis & St. Louis*

[1] See page 14, *supra*.

case, to place under the lien of the First Mortgage equipment having a value of $5,349,482.37.

The only equipment which the Debtor on that date had available for that purpose consisted of 52 units of equipment acquired by the use of free funds (not under equipment trusts), having a book value at the date of acquisition of $49,027.16, and its equity in 3,705 units of equipment acquired under the Equipment Trusts of 1923, 1924, and 1929, and the Baldwin Lease of 1931, having a total book value at the date of acquisition of $13,006,454.87, making a total of 3,757 units, having a book value at the date of acquisition of $13,055,482.03.[1] Inasmuch as $5,297,329.36 in principal amount of equipment obligations were then outstanding under the three equipment trusts and the Baldwin Lease,[2] the Debtor's equity in this equipment, after taking into account accrued depreciation, could not have greatly exceeded the amount required to maintain under the First Mortgage equipment equal in value to the Original Value of Original Equipment.

As we have pointed out, the covenant in the first paragraph of Section 9 of Article Fourth of the First Mortgage goes beyond the limited maintenance and replacement covenant which the court was considering in the *Minneapolis & St. Louis* case. It is also a covenant to make all needful and proper "additions", and it has the effect of causing the lien of the First Mortgage to attach to all after acquired equipment which is needed for the efficient operation of the mortgaged enterprise. Giving effect to the covenant in its entirety, the conclusion seems clear that the Debtor's equity in all of the equipment in controversy is subject to the First Mortgage as a first lien.

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[1] Although the depreciated book values of this equipment on March 1, 1932, are not shown by the record, they were obviously much less than the amounts above stated.

[2] This figure represents the aggregate principal amount of equipment trust obligations which were unmatured on March 1, 1932, as shown by paragraph 83 of the Stipulation (R. 1068-1070) and by I. C. C. Exhibit No. 110 (R. 2517).

The Contentions of the Refunding Mortgage Trustee.

The brief of the Refunding Mortgage Trustee ignores the covenant in the first paragraph of Section 9 of Article Fourth and the provision in Granting Clause Fifth of the First Mortgage; the argument in the brief (pp. 32-40) is directed exclusively to the provisions of the second paragraph of Section 9 of Article Fourth[1] and to the provisions of the first paragraph of Section 5 of Article Seventh.[2]

The second paragraph of Section 9 of Article Fourth reads as follows:

> "All equipment upon which this indenture is or shall be a first lien shall be marked so as to identify the same as equipment subject to this indenture as a first lien thereon, and the Company will at all times keep such equipment in good order and condition, reasonable wear and tear excepted, and marked distinctively as aforesaid, and will replace such of said equipment as shall be worn out or destroyed with other equipment of at least equal value on which this indenture shall constitute a first lien.
>
> "The Company will, at such times as the Trustees may request, furnish to them a complete list of all equipment upon which this indenture is or shall be a first lien; but the fact that any such equipment shall not be marked or included in such list shall not create any presumption that the same is not subject to this indenture as a first lien thereon."

The first paragraph of Section 5 of Article Seventh reads as follows:

> "Section 5.—The Company shall have full power from time to time in its discretion to dispose of free from the lien hereof any of the rails, equipment, machinery, tools and implements at any time subject hereto that may have become unsuitable or unneces-

[1] I. C. C. Exhibit No. 5, pp. 76-77.
[2] I. C. C. Exhibit No. 5, p. 111.

sary for use, first or simultaneously replacing the same by new rails, equipment, machinery, tools and implements of substantially equal value to the Company, which shall become subject to the lien of this indenture in like degree; and any subsidiary company may dispose of similar property, replacing it with property of substantially equal value."

The covenants in the second paragraph of Section 9 of Article Fourth are special covenants which apply only to equipment upon which the First Mortgage is a first lien. They in no way limit the covenant in the first paragraph of the section, which requires the Debtor to make such "additions" to its equipment and other property as may be necessary to keep up the operating efficiency of the mortgaged enterprise.

The first paragraph of Section 5 of Article Seventh merely confers upon the Debtor the power to dispose of equipment and other property which has become unsuitable and unnecessary for use. It in no way affects the scope of the covenant in the first paragraph of Section 9 of Article Fourth.

The Refunding Mortgage Trustee contends (1) that the maintenance and replacement provisions above quoted apply only to equipment "worn out or destroyed" or "disposed of", (2) that these maintenance and replacement provisions cannot be complied with except by the use of equipment on which the First Mortgage will be a first lien, and (3) that the lien of the First Mortgage cannot attach to equipment by virtue of these maintenance and replacement provisions until such equipment has been marked or otherwise specifically allocated as replacements.

The first two contentions may be disposed of briefly. They have no bearing upon the question whether the equipment in controversy was brought under the lien by virtue of the covenant in the first paragraph of Section 9 of Article Fourth. As we have pointed out, that covenant is more than a mere covenant to replace specific units of equipment as they are retired from service: it is a covenant to make all needful and proper "additions". The

scope of that covenant is not limited to equipment upon which the First Mortgage is a first lien.

The third contention of the Refunding Mortgage Trustee requires more detailed comment.

The grant of after acquired equipment contained in Granting Clause Fifth, as supplemented by the covenant in the first paragraph of Section 9 of Article Fourth, includes in its scope all after acquired equipment falling within the description of "needful and proper additions". There is nothing in the language of either of these provisions to suggest that a marking, or any other form of specific allocation, of the equipment is a condition precedent to the attaching of the lien.

Nor is there anything in the language of the second paragraph of Section 9 of Article Fourth which imposes such a condition precedent.

The covenant as to marking, contained in that paragraph is not, as stated on page 33 of the brief of the Refunding Mortgage Trustee, a covenant to mark "all equipment subject to the Mortgage". It is a covenant to mark "All equipment upon which this indenture is or shall be a first lien".[1]

The language of the covenant, which applies to all equipment upon which the First Mortgage is a first lien, and not merely to equipment acquired as replacements, makes clear that the covenant relates to equipment already subject to the lien and that it does not impose a condition precedent to the attaching of the lien. This is shown by the provision (in the last sentence of the paragraph) that the failure to mark shall not create any presumption that the equipment is not subject to the lien.

Nor was a marking or other specific allocation of the equipment in controversy necessary to identify it as equipment falling "within the description of the covenant" in the first paragraph of Section 9 of Article Fourth. We are not dealing here with a divisional mortgage but with

[1] Inasmuch as all of the equipment in controversy was acquired under equipment trusts, it was not, by the terms of this covenant, required to be marked.

a system mortgage, which covers all of the lines of railroad owned by the Debtor. The equipment in controversy was acquired for use and was actually used on the mortgaged lines; its dedication to that use identifies it as coming "within the description of the covenant".

The three cases cited at pages 37-40 of the brief of the Refunding Mortgage Trustee[1] are not in point.

The *Wabash Western* case involved a divisional mortgage, which by its terms was to cover only "the rolling stock belonging" to the Omaha Division (p. 891). The requirement as to marking was for the express purpose of designating the equipment "belonging" to the Omaha Division and "distinguishing it from the rolling stock appurtenant to the main line and other branches of the road" (p. 891). In other words, under the peculiar provisions of the Omaha Division mortgage, equipment did not come within the description of the granting clauses unless it had been designated by a marking as being equipment "belonging" to the Omaha Division. The mortgagor company having failed to perform its covenant to designate, the foreclosure purchasers of the Omaha Division property sought to make good the deficiency out of the general equipment owned by a successor company, to which the liens of the successor company's mortgages had already attached. The court held merely that the lien of the successor company's mortgages could not be displaced. The opinion does not indicate whether the successor company had assumed the covenants of the mortgagor company under the mortgage.

The *Metropolitan Trust Company* case and the *New York and Queens County Railway* case each involved the question of the extent to which the covenants of the original mortgagor company became binding upon a successor

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[1] *United States Trust Co.* v. *Wabash W. Ry. Co.*, 38 Fed. 891 (Circ. Ct., S. D. Iowa, W. D., 1889), appeal dismissed, 140 U. S. 703 (1891); *Metropolitan Trust Co.* v. *Chicago & E. I. R. Co., et al.*, 253 Fed. 868 (C. C. A., 7th Circ., 1918); *Guaranty Trust Co.* v. *N. Y. & Q. C. Ry. Co.*, 253 N. Y. 190, 170 N. E. 887 (N. Y., 1930).

company after a consolidation or merger, whereas in the present case the equipment in controversy was acquired by the original mortgagor company (the Debtor).

In the *Metropolitan Trust Company* case, the court, after holding that the after-acquired property clauses of the Metropolitan mortgage did not survive the consolidation of the mortgagor company, held that the successor company was under no contractual obligation to maintain and replace the mortgaged equipment. The court expressly found (p. 879) that the usual covenant for maintenance and replacement of equipment was not to be found in the Metropolitan mortgage. It then went on to state (p. 879) by way of dictum that, "if it were there, or if the provisions present were properly to be construed as such a covenant, no lien would attach merely because of the mortgagor's breach of the covenant through its failure to maintain and replace the Coal Company equipment of 1894". This dictum goes no further than to state the obviously correct principle that the covenant could not be enforced in respect of equipment acquired by a successor company which had not assumed the obligations of the mortgagor company.

In the *New York and Queens County Railway* case, the question was whether the lien of the Steinway mortgage attached to property acquired subsequent to a merger by a successor company which had not assumed the obligations of the mortgagor company.

The controlling principle of the case is stated in that part of the opinion which is quoted on pages 38-39 of this brief.

After holding that the successor company was under no statutory or contractual duty to subject the property to the lien of the Steinway mortgage and that the lien of the Steinway mortgage did not spread by reason of estoppel or accession, the court then considered whether the extension of the lien of the Steinway mortgage to the new power house and car barn could be justified on the theory that the successor company was under an equitable duty to provide a substituted security when it abandoned or disman-

tled the old Steinway power house and car barn. The court held that, inasmuch as the old Steinway power house and car barn were not abandoned or dismantled until after the new power house and car barn had been acquired and had become subject to the lien of the successor company's mortgage, no equity arose in favor of the Steinway bondholders which could displace the existing lien of the successor company's mortgage.

In the present case, the equipment in controversy was acquired, not by a successor company, but by the original mortgagor company (the Debtor), which was bound by its covenant to make all "additions" to its equipment which were "needful and proper" to keep up the operating efficiency of the mortgaged enterprise. The holders of Refunding Mortgage Bonds can establish no superior equity with respect to equipment coming "within the description of the covenant" in the First Mortgage.

As we interpret the provisions of the First Mortgage, they clearly evidence a purpose that the security under the mortgage shall at all times consist of a railroad fully equipped for efficient operation. The interpretation placed upon these provisions by the Refunding Mortgage Trustee would permit that purpose to be defeated: the Debtor could, over a period of years, allow the mortgaged enterprise to become denuded of equipment, thus leaving the bondholders with an empty shell.

By purchasing all of its new equipment under equipment trusts, the Debtor could, under the Refunding Mortgage Trustee's interpretation of the "exception clause", entirely escape the operation of the after-acquired property clauses, even as to equipment acquired for use and used exclusively on the mortgaged lines.

Under the Refunding Mortgage Trustee's interpretation of the equipment covenants, as the mortgaged equipment became obsolete and new equipment was needed to maintain the operating efficiency of the mortgaged enterprise, the Debtor would be under no duty to acquire new equipment, except to replace specific units as they became ready for the scrap heap. And even as to equipment ac-

quired as replacements, the lien of the First Mortgage would not attach if the Debtor neglected to make a specific allocation, by marking or otherwise.

Thus, upon a foreclosure, the bondholders might find themselves with a lien upon a gutted property—a line of railroad without equipment.

Surely, the draftsman of the First Mortgage did not intend to create so illusory a thing as a vanishing security.

POINT III.

THE NORTHERN CALIFORNIA EXTENSION IS SUBJECT IN ITS ENTIRETY TO THE FIRST MORTGAGE AS A FIRST LIEN THEREON.

A. FACTS.

The Construction of the Northern California Extension.

The Northern California Extension connects with the main line of the Debtor at Keddie, Plumas County, California, and extends to a connection with the Great Northern Railway at Bieber, Lassen County, California, a distance of approximately 112 miles (R. 1076).

Construction of the Northern California Extension was commenced on August 16, 1930, and by December 31, 1930, there had been completed 32% of the grading, 16% of the tunneling, practically all of the clearing, and a large percentage of the culvert installation; construction of concrete bridge foundations was largely under way. Connection with the Great Northern Railway at Bieber was made on November 10, 1931, and freight service was then inaugurated under the jurisdiction of the construction department. Owing to the approach of the winter season, complete ballasting of the line, as well as the completion of certain other facilities, was deferred until 1932. Ballasting was practically completed in 1932, and on June 1, 1932, the line was placed in full commercial operation for freight service (R. 1077).

The Method of Financing.

The total cost of construction of the Northern California Extension was in excess of $10,000,000 (the cost to May 31, 1932, was $10,183,641.90). The cost of construction was financed (1) by the sale at 97½ to The Western Pacific Railroad Corporation of $5,000,000 principal amount of First Mortgage Bonds, (2) by the sale at par to the A. C. James Co. of $5,000,000 principal amount of Debentures issued under the Indenture dated July 1, 1930 (I. C. C. Exhibit No. 50, R. 2327, 2335), and (3) by loans obtained by the Debtor from Reconstruction Finance Corporation aggregating $559,408 (R. 1078).

The first step in the actual financing was the sale of $1,000,000 principal amount of said First Mortgage Bonds, the deposit on February 11, 1931, of the cash proceeds thereof with the First Mortgage Trustees and the simultaneous withdrawal of the cash proceeds to reimburse the Debtor for expenditures made by it out of its own funds for the construction of the Northern California Extension between February 1, 1929, and November 30, 1930. By February 11, 1931, before any of the Debentures had been issued and before any of the loans had been obtained from Reconstruction Finance Corporation, the Northern California Extension had come into existence as a continuous right of way with substantial improvements, owned by the Debtor, and used as a basis for the withdrawal of deposited cash under the First Mortgage (R. 1077, 1079-1082, 1084-1085, 1088-1089).

The Negotiations with A. C. James Co.

Under date of May 14, 1929, while the original application of the Debtor to the Interstate Commerce Commission for a certificate of public convenience and necessity for the construction of the Northern California Extension was still pending before the Commission, the A. C. James Co. made to the Debtor a written offer (I. C. C. Exhibit No. 45; R. 1078-1079, 2308, 2316), in which it stated:

"In the event your application for a certificate of public convenience and necessity is granted by the Interstate Commerce Commission, this company is prepared to advance to you, from time to time as requested by you, all moneys required for the construction of the proposed Northern Extension. Such advances are to be evidenced by your bonds or notes, bearing interest at 5 per cent. per annum, payable semi-annually; principal payable January 1, 1950; said bonds or notes to be redeemable in whole or part, at par, at your option upon any interest date, on thirty days' notice; said bonds or notes are to be secured by a trust indenture creating a first lien upon the proposed Northern Extension as security for said bonds or notes and expressly providing that you will not place any additional mortgage indebtedness upon any other real property owned by you, over and above the bonds authorized under your present existing first mortgage of June 26, 1916, without providing, from the proceeds of such additional financing, for the redemption of these bonds."

This financing was not carried out on the basis outlined in I. C. C. Exhibit No. 45 (R. 2308, 2315), but, under date of June 19, 1929, the A. C. James Co. made a new offer (I. C. C. Exhibit No. 46; R. 1079, 2319), in which it stated:

"In the event a certificate of public convenience and necessity is granted by the Interstate Commerce Commission, this company is prepared to advance to you, from time to time, as requested by you, fifty per cent. (50%) of all moneys required for the construction of the proposed Northern Extension, our advances to be limited in the aggregate to the sum of Five Million Dollars ($5,000,000).

"We understand that you propose to provide the remaining funds required for the extension by application of current funds and/or sale of First Mortgage Bonds, under your existing mortgage of June 26, 1916. The advances to be made you by this company are to be evidenced from time to time as made to you, by your debenture bonds or notes, bearing interest at 5 per

cent. per annum, payable semi-annually; principal payable January 1, 1950; said bonds or notes to be redeemable in whole or in part, at par at your option upon any interest date, on thirty days' notice; said bonds or notes are to be issued under an indenture which will contain, in addition to the conventional provisions of such agreements, an express provision that you will not place any mortgage indebtedness or other lien upon any property owned by you, other than the bonds authorized under your existing first mortgage of June 26, 1916, without providing, from the proceeds of such additional financing, for the redemption of the debenture bonds or notes issued to us under the terms of this offer. This shall not be construed, however, as limiting your company in the issue of equipment trust certificates or other purchase money obligations.

"In view of the fact that Mr. A. C. James, a director of your company, is substantially interested in this company, we are advised that this offer on our part necessarily takes the form of an offer to bid at par for the securities mentioned above upon a public sale, and that your company is under the necessity of complying with the requirements of public sale provided by the Clayton Act as to such securities and cannot commit itself to dispose of the securities to this company on the basis indicated above. It is intended, however, that this letter shall be a firm commitment to you that this company will bid for such securities on the terms indicated, at any such public sale.

* * * * *

"We understand that you propose, in reliance upon this offer, to make definite commitments in connection with the construction of the proposed Northern Extension. It is further understood that this offer is *in lieu of and in substitution for our offer* of May 14, 1929, *which contemplated the issue to us of bonds or notes secured by a first lien* on the Northern Extension as then proposed and described in the original application for a certificate of public convenience and necessity filed February 8, 1929."

This offer was accepted by the Executive Committee of the Debtor at a meeting held June 19, 1929, Mr. A. C. James being present but not voting (Exhibit VII to I. C. C. Exhibit No. 80; R. 1079, 2444). The minutes of this meeting show that the original offer (I. C. C. Exhibit No. 45, R. 2308, 2316) was based upon the understanding that the proposed new line could be constructed for approximately $5,000,000.

THE ISSUE OF FIRST MORTGAGE BONDS.

The $5,000,000 principal amount of First Mortgage Bonds issued to finance in part the construction of the Northern California Extension were offered from time to time at public sale to the highest bidder in blocks of $1,000,000 principal amount or less, all of them being purchased by The Western Pacific Railroad Corporation at 97½ and accrued interest. The notice, dated January 8, 1931 (I. C. C. Exhibit No. 93, sheet 1, R. 2459), calling for bids on the first block of $1,000,000 principal amount, referred to the specifications, form of proposals and form of contract on file with the Debtor. The specifications contained the following statement (I. C. C. Exhibit No. 93, sheet 2, R. 2459):

> "Said First Mortgage constitutes a first lien on the main line of railroad of the Company extending from San Francisco, California, to Salt Lake City, Utah, and branches, aggregating 1050.5 miles, more or less, of first track, the Company's terminal and other railroad properties in the cities of San Francisco, Oakland and elsewhere, and certain of its rolling stock and equipment. Upon the completion of the construction and/or acquisition of the Company's 'Northern California Extension' its main line of railroad will aggregate 1198.5 miles, more or less. A map of the Company's railroad system is hereto annexed."

The bid of The Western Pacific Railroad Corporation (I. C. C. Exhibit No. 93, sheet 6, R. 2459) stated that it was made

> "In accordance with and subject to all the terms of the notice dated January 8, 1931, published by

> your Company in newspapers of New York and San Francisco, and in accordance with the specifications referred to in said notice, which notice and specifications have been examined by the undersigned, * * *."

The notices, specifications and bids in connection with the sale of the remainder of the bonds were substantially identical with those contained in I. C. C. Exhibit No. 93. (R. 1079-1080, 2459.)

Mr. A. C. James was then a director of The Western Pacific Railroad Corporation (R. 1080).

The bonds were authenticated and delivered by the First Mortgage Trustees pursuant to paragraph B of Section 2 of Article Second of the First Mortgage,[1] which provides for the authentication and delivery of bonds against the deposit with the Trustees of the cash proceeds of their sale. The dates of authentication and delivery, the principal amounts of bonds authenticated and delivered, the amounts of cash proceeds deposited, and the numbers of the I. C. C. exhibits containing the application papers furnished to the First Mortgage Trustees are as follows (R. 1080, 2358-2359, 2378-2380):

Date	Principal Amount of Bonds	Amount of Cash Proceeds	I. C. C. Exhibit No.
Feb. 11, 1931	$1,000,000	$975,000	61
June 25, 1931	1,000,000	975,000	63
July 23, 1931	900,000	877,500	65
Nov. 25, 1931	750,000	731,250	68
Jan. 8, 1932	350,000	341,250	70
Jan. 29, 1932	1,000,000	975,000	72

The deposited cash was withdrawn by the Debtor on requisitions filed with the First Mortgage Trustees, pursuant to Section 2 of Article Second of the First Mortgage, to reimburse the Debtor for expenditures made in the construction of the Northern California Extension, the expenditures certified being equal to the principal amount

[1] I. C. C. Exhibit No. 5, p. 44.

of the bonds represented by the deposited cash, as required by the provisions of the First Mortgage (p. 45) (R. 1080-1081, 1872).

The application papers contained in the requisitions included in each case resolutions of the Executive Committee of the Debtor, pursuant to subparagraph First of Section 2 of the First Mortgage (pp. 45-46), a certificate signed by officers of the Debtor, pursuant to subparagraphs Second (pp. 46-48), Sixth (pp. 54-55), Seventh (pp. 55-56) and Eighth (pp. 56-57) of Section 2 of Article Second, certifying, *inter alia*, the amounts and dates of the expenditures made, and an opinion of the Debtor's General Counsel, pursuant to clause (c) of subparagraph Sixth (p. 55) and clause (c) of subparagraph Seventh (p. 56) of Section 2 of Article Second (I. C. C. Exhibits Nos. 62, 64, 66, 67, 69, 71, and 73, R. 2368, 2378-2380).

The resolutions in each case recited that expenditures of a specified amount had been made between specified dates "for the construction and/or acquisition of a new line of railroad by this Company known as its 'Northern California Extension' to connect with the existing main line of the Company in the vicinity of Keddie, Plumas County, California, and extending to a point at or near Bieber, Lassen County, California; and including a line of railroad to be acquired and/or constructed by this Company jointly with Great Northern Railway Company to connect with said line of railroad first above mentioned via trackage rights, and extending from a point at or near Lookout, Modoc County, California, to a point at or near Hambone, Siskiyou County, California", and also contained the language "all portions of said extension which have been constructed and/or acquired being subject to the lien of said First Mortgage and now in the possession of this Company" (I. C. C. Exhibit No. 62, sheet 10, which is typical of all of the subsequent requisitions, R. 2368).

The officers' certificate in each case stated that expenditures of a specified amount had been made between specified dates "for the construction of a new line of railroad, known as this Company's 'Northern California Extension'", describing the line as in the resolutions of the

Executive Committee (I. C. C. Exhibit No. 62, sheet 11, R. 2368), and also stated:

> "3. That so far as known or believed by us the property so constructed or acquired as aforesaid, is not subject to any lien or charge, except (a) necessarily undetermined liens or charges ordinarily incident to construction and (b) the lien of said First Mortgage. That there have been executed and delivered to the Company all deeds, conveyances, or other instruments necessary to vest the title to the property constructed or acquired as aforesaid in the Company, subject only to the liens or charges aforesaid." (I. C. C. Exhibit No. 62, sheet 13, R. 2368.)

The opinion of counsel in each case stated that title to all those portions of the Debtor's new line of railroad known as its "Northern California Extension" and to all of the property mentioned in the officers' certificate "has vested in The Western Pacific Railroad Company, subject only to liens or charges certified in said certificate and to liens or charges of the character not required to be certified under the terms of paragraph 'Second' of subsection D of Section 2 of Article Second of The Western Pacific Railroad Company's First Mortgage dated June 26, 1916, and all deeds, conveyances or other instruments necessary to vest the title to said property in said Company have been executed and delivered to it, and all said portions of said extension and said property are subject to the lien of this Company's First Mortgage, and no supplemental indenture or instruments of further assurance are necessary to subject said property, or any part thereof, to the lien of said First Mortgage, subject only to the liens and charges aforesaid" (I. C. C. Exhibit No. 62, sheets 8-9, R. 2368).

The resolutions authorizing the withdrawal of the deposited cash were adopted by the Executive Committee of the Debtor at its meetings held on February 11, June 25, July 23, October 15, November 17, and December 21, 1931, and January 29, 1932 (I. C. C. Exhibit No. 86, R. 2455). Mr. A. C. James was present at each of those meetings (R. 1081).

The dates and amounts of the withdrawals of deposited cash, the numbers of the requisitions and their I. C. C. exhibit numbers are as follows (R. 1081, 2368, 2378-2380):

Requisition No.	Date	Amount	I. C. C. Exhibit No.
244	Feb. 11, 1931	$975,000.00	62
246	June 25, 1931	975,000.00	64
247	July 23, 1931	812,571.03	66
248	Oct. 24, 1931	64,928.97	67
250	Nov. 25, 1931	731,250.00	69
251	Jan. 8, 1932	341,250.00	71
252	Jan. 29, 1932	975,000.00	73

The amounts and dates of the expenditures and the itemization of the expenditures, as set forth in the officers' certificates contained in these requisitions, are as follows (R. 1081-1083):

Req. No. 244 Amount $999,998.98	Date February 1, 1929, to November 30, 1930
Engineering	$ 244,777.82
Land for Transportation Purposes	121,377.67
Grading	589,393.37
Tunnels and Subways	44,450.12
Total Expenditure	$ 999,998.98

Req. No. 246 Amount $1,000,000.00	Date January 1, 1931, to April 30, 1931
Engineering	$ 25,001.21
Land for Transportation Purposes	16,965.14
Grading	358,532.33
Tunnels and Subways	298,589.02
Bridges, Trestles and Culverts	286,163.05
Ties	2,014.38
Rails	3,021.57
Track Laying and Surfacing	130.00
Right of Way Fences	3,198.56
Crossings and Signs	3,040.97
Station and Office Buildings	990.26
Water Stations	717.55
Other Expenditures—Road	1,635.96
Total Expenditure	$1,000,000.00

Req. No. 247 Amount $833,406.18	Date May 1, 1931, to June 30, 1931
Engineering	$ 27,108.10
Land for Transportation Purposes	58,732.92
Grading	346,349.05
Tunnels and Subways	67,990.50
Bridges, Trestles and Culverts	157,575.37
Ties	31,861.33
Rails	58,146.84
Other Track Material	21,748.24
Ballast	349.54
Track Laying and Surfacing	22,993.58
Right of Way Fences	335.64
Crossings and Signs	3,213.59
Station and Office Buildings	216.72
Water Stations	7,532.40
Telegraph and Telephone Lines	14,461.63
Other Expenditures—Road	14,790.73
Total Expenditure	$ 833,406.18

Req. No. 248 Amount $66,593.82	Date August 1, 1931, to August 31, 1931
Bridges, Trestles and Culverts	$ 66,593.82

Req. No. 250 Amount $750,000.00	Date August 1, 1931, to September 30, 1931
Engineering	$ 16,801.95
Grading	29,350.73
Tunnels and Subways	49,636.90
Bridges, Trestles and Culverts	140,588.13
Ties	103,826.07
Other Track Material	73,112.72
Ballast	191,428.53
Track Laying and Surfacing	139,660.60
Water Stations	5,594.37
Total Expenditure	$ 750,000.00

Req. No. 251 Amount $350,000.00	Date September 1, 1931, to October 31, 1931
Engineering	$ 31,703.24
Tunnels and Subways	100,386.60
Bridges, Trestles and Culverts	217,910.16
Total Expenditure	$ 350,000.00

Req. No. 252 Amount $1,000,000.00	Date June 1, 1931, to November 30, 1931
Grading	$1,000,000.00

The Issue of Debentures.

The $5,000,000 principal amount of Debentures issued to finance in part the Northern California Extension were offered at public sale to the highest bidder in a single block, all of them being purchased by the A. C. James Co. at par and accrued interest (I. C. C. Exhibits Nos. 48 and 49; R. 1084-1085, 2326-2327). The notice, dated January 8, 1931 (I. C. C. Exhibit No. 48, sheet 14, R. 2326), calling for bids, referred to the specifications, form of proposals and form of contract on file with the Debtor. The specifications contained the following statement (I. C. C. Exhibit No. 48, sheet 5, R. 2326):

> "The main line of railroad of the Company extends from San Francisco, California, to Salt Lake City, Utah, with branches, and aggregates 1050.5 miles, more or less of first track. Upon the completion of the Company's 'Northern California Extension' its main line of railroad will aggregate 1198.5 miles, more or less. A map of the Company's railroad system is hereto annexed.
>
> "The First Mortgage of this Company dated June 26, 1916, securing this Company's First Mortgage Bonds, whereunder not more than $50,000,000. thereof may be outstanding at any one time, is a first lien on said main line of railroad."

The bid of the A. C. James Co. (I. C. C. Exhibit 49, R. 2327) stated that it was made "In accordance with and subject to all the terms of the notice dated January 8, 1931, published by your Company in newspapers of New York and San Francisco, and in accordance with the specifications referred to in said notice, which notice and specifications have been examined by the undersigned, * * *".

Mr. A. C. James was then the President and a Director of the A. C. James Co. (R. 184).

The Debentures were authenticated and delivered pursuant to Article II of the Indenture dated July 1, 1930 (R. 1084).

Section 1 of Article II provides (I. C. C. Exhibit No. 50, pp. 16-17, R. 2327, 2335) for the authentication and delivery of Debentures "for the purpose of constructing, purchasing, and/or otherwise acquiring the proposed so-called Northern California Extension" (which is described by its termini), "*provided, however,* that not to exceed 50% of the cost of any such construction, purchase or acquisition, may be met by the issue of the Debentures hereunder and the other 50% of such cost shall be paid by the Company by the sale of First Mortgage bonds of the Company issued under the Company's First Mortgage dated June 26, 1916, and/or funds derived from other sources; * * *".

Section 2 (pp. 17-19) specifies the application papers to be furnished to the Trustee, including, *inter alia,* (1) a written order of the Debtor, (2) a certificate signed by officers of the Debtor stating, *inter alia,* that liabilities to an amount specified have been incurred, or within 60 days next succeeding the date of the certificate will be incurred, and/or that expenditures to an amount specified have been made, for the purposes set forth in Section 1, and that the total amount of liabilities and/or expenditures so certified is equal to at least twice the aggregate principal amount of the Debentures then applied for, and (3) an opinion of counsel to the effect that the issue of the Debentures has been duly authorized by any governmental bodies having jurisdiction.

Under the terms of the Indenture (I. C. C. Exhibit No. 50, R. 2327, 2335), the Debentures were entirely unsecured.

The dates on which the Debentures were authenticated and delivered and the respective principal amounts thereof are as follows (R. 1084-1085):

Date	Amount
Feb. 27, 1931	$1,000,000
March 26, 1931	600,000
May 25, 1931	530,000
June 20, 1931	995,000
Aug. 25, 1931	309,000
Oct. 20, 1931	600,000
Nov. 25, 1931	120,000
Jan. 28, 1932	350,000
March 28, 1932	347,000
May 31, 1932	149,000

The officers' certificate contained in the requisition for the first $1,000,000 principal amount of Debentures shows that, by February 1, 1931, a total of $1,682,298.18 had been expended by the Debtor on the Northern California Extension (I. C. C. Exhibit No. 95, sheet 10, R. 2464).

THE CANCELLATION OF THE DEBENTURES.

On March 1, 1932, contemporaneously with the execution and delivery of the Refunding Mortgage and the authentication and delivery of the initial issue of $14,380,000 principal amount of Refunding Mortgage Bonds, the A. C. James Co. surrendered to the Trustee under the Indenture dated July 1, 1930 (I. C. C. Exhibit No. 50, R. 2327, 2335) for cancellation $4,504,000 principal amount of Debentures, being all of the Debentures then outstanding. These Debentures were surrendered for cancellation by the A. C. James Co. in exchange for a note of the Debtor in the principal amount of $4,504,000 secured by the pledge of $5,630,000 principal amount of Refunding Mortgage Bonds (R. 1085).

The $347,000 principal amount of Debentures authenticated and delivered on March 28, 1932, were simultaneously surrendered to the Trustee under the Indenture dated July 1, 1930 (I. C. C. Exhibit No. 50, R. 2327, 2335) for cancellation, in exchange for the delivery to the A. C. James Co. of a note of the Debtor in like principal amount secured by the pledge of $433,500 principal amount of Refunding Mortgage Bonds. A similar procedure was fol-

lowed in the case of the $149,000 principal amount of Debentures authenticated and delivered on May 31, 1932, the principal amount of Refunding Mortgage Bonds then pledged being $186,000 (R. 1085-1086).

THE EXECUTION AND DELIVERY OF THE REFUNDING MORTGAGE AND THE ISSUE OF REFUNDING MORTGAGE BONDS.

The aggregate principal amount of bonds authenticated and delivered under the Refunding Mortgage is $18,999,500. The dates on which these bonds were authenticated and delivered to the Debtor and the respective principal amounts thereof are as follows:

Date	Amount
March 1, 1932	$14,380,000
March 28, 1932	433,500
May 31, 1932	186,000
Feb. 27, 1933	4,000,000

All of the bonds were bonds of Series A, except the $4,000,000 principal amount authenticated and delivered on February 27, 1933, which were of Series B (R. 1086).

All of the bonds were pledged with the A. C. James Co., Reconstruction Finance Corporation, and The Railroad Credit Corporation (R. 1086-1087).

The Series A bonds were authenticated and delivered to the Debtor pursuant to Section 1 of Article Two of the Refunding Mortgage,[1] which provides for an initial issue of $15,000,000 principal amount of bonds upon the furnishing by the Debtor to the Refunding Mortgage Trustee of a certified copy of resolutions of the Board of Directors of the Debtor requesting the authentication and delivery of the bonds, together with an opinion of counsel with respect to the due authorization of the issue of the bonds by any governmental bodies having jurisdiction (R. 1087).

The Series B bonds were authenticated and delivered to the Debtor pursuant to Sections 1 and 2 of Article Two of the Refunding Mortgage.[2] Under Section 2, $5,000,000

[1] I. C. C. Exhibit No. 6, pp. 36-37.
[2] I. C. C. Exhibit No. 6, pp. 36-44.

principal amount of Refunding Mortgage Bonds were required to be reserved for the purpose of refunding the $5,000,000 principal amount of Debentures issued under the Indenture dated July 1, 1930 (pp. 37-38), but it was provided (p. 43) that bonds reserved under Section 2 for the purpose of refunding Debentures could be released from reservation by a resolution of the Board of Directors of the Debtor declaring them to be no longer needed for that purpose, in which event such reserved bonds might be authenticated and delivered in accordance with the provisions of either Section 1 or Section 3[1] of Article Two. The Board of Directors of the Debtor, at a meeting held on July 14, 1932, adopted resolutions declaring that the $5,000,000 principal amount of Refunding Mortgage Bonds reserved under Section 2 for the purpose of refunding the $5,000,000 principal amount of Debentures need no longer be held or reserved for that purpose (Exhibit H to I. C. C. Exhibit No. 90, R. 2457), and the Series B bonds were accordingly authenticated and delivered in accordance with the provisions of Section 1 of Article Two (R. 1087-1088).

None of the Refunding Mortgage Bonds were authenticated and delivered upon the basis of the construction or acquisition of any property, as permitted by Section 3.

The Advances by Reconstruction Finance Corporation.

The construction of the Northern California Extension was financed in part with funds advanced by Reconstruction Finance Corporation on the following dates and in the following amounts:

Date	Amount
March 1, 1932	$259,000
June 29, 1932	268,061
Aug. 1, 1932	32,347

[1] Section 3 provides for the authentication and delivery of bonds upon the basis of the construction or acquisition of additional property (I. C. C. Exhibit No. 6, pp. 44-48).

These advances formed part of loans of larger amounts made by Reconstruction Finance Corporation to the Debtor, which were secured by the pledge of Refunding Mortgage Bonds and other collateral (R. 1088-1089).

In its application to Reconstruction Finance Corporation dated February 5, 1932, for the loan which included the first advance of $259,000 on account of the Northern California Extension (I. C. C. Exhibit No. 82; R. 1089, 2449, 2451), the Debtor stated (I. C. C. Exhibit No. 82, sheet 6, and Schedule P, R. 2449, 2451) that $259,000 was required on or before March 1, 1932 "to pay contractors for work in constructing the branch line (now nearly completed)", the reference being to the Northern California Extension. It further stated (I. C. C. Exhibit No. 82, sheet 7, R. 2449, 2451) that the Refunding Mortgage "will be a lien on all of the properties, and assets of the Applicant [*i. e.*, the Debtor] subject only to equipment trust obligations and the lien of the Applicant's First Mortgage". The property of the Debtor was described as consisting of 925.706 miles of main line running from Salt Lake City, Utah, to San Francisco, California, with various branches, including the Northern California Extension, "making a total of main line and branch line mileage of approximately 1163 miles, together with adequate side tracks and industrial spur tracks".

In its application to Reconstruction Finance Corporation dated May 23, 1932, for the loans which included the remainder of the advances made for the construction of the Northern California Extension (I. C. C. Exhibit No. 87; R. 1089, 2456), the Debtor stated that $253,311 was required on or before June 20, 1932, for work in constructing the line, "$164,133 being either past due or payable in June to contractors for work in constructing such line, and the balance to provide funds to pay for work under way in the Fall of 1931 which was temporarily discontinued by reason of winter conditions and which must now be carried out" (I. C. C. Exhibit 87, p. 3, R. 2456). It further stated that $14,750 was required on or before July 1, 1932 (I. C. C. Exhibit No. 87, p. 4, R. 2456), and $32,347

on or before August 1, 1932 (I. C. C. Exhibit No. 87, p. 5, R. 2456) to pay for work of similar character. The details of the work for which these advances were sought are set forth in Schedule P annexed to I. C. C. Exhibit No. 87 (R. 2456). An examination of Schedule P shows that the greater part of the expenses was for labor.

This application (I. C. C. Exhibit No. 87, R. 2456) contains the following statement (p. 15):

> "The General and Refunding Mortgage is a first lien on certain securities having a book value of $2,374,655, and a second lien on all of the remaining property of the Railroad Company, subject only to $49,290,100 First Mortgage Bonds now outstanding and $4,550,000 of Equipment Trust Certificates."

The report of the Commission which formed the basis of the certificate of approval, issued February 29, 1932 (I. C. C. Exhibit No. 52; R. 1089, 2340), states that the Refunding Mortgage Bonds to be pledged as collateral for the loan "are to be issued under a proposed new general and refunding mortgage and will be a second lien upon all the carrier's property, including personal property" (I. C. C. Exhibit No. 52, p. 3, R. 2340).

The Recordation of the First Mortgage and of the Refunding Mortgage.

The Northern California Extension is situate entirely within the counties of Plumas and Lassen, California (R. 1076).

The First Mortgage was recorded in both of these counties on July 17, 1916 (R. 1066-1067). The Refunding Mortgage was recorded in Plumas County on March 12, 1932, and in Lassen County on March 14, 1932 (R. 1067).

B. ARGUMENT.

The contentions advanced by the Refunding Mortgage Trustee with respect to the Northern California Extension we understand to be as follows:

(a) The granting clauses of the First Mortgage permit the Debtor, by the use of its credit or free funds, to construct extensions free of the lien of the First Mortgage; therefore, the First Mortgage is a lien on the Northern California Extension as an entirety only to the extent that it was financed by the use of First Mortgage Bonds or deposited cash, and, to the extent that it was not so financed, the lien of the Refunding Mortgage ranks prior to or *pari passu* with the lien of the First Mortgage, because the granting clauses of the Refunding Mortgage specifically describe the Northern California Extension, and because the Refunding Mortgage provides that the property conveyed thereunder is subject to the lien of the First Mortgage only in so far (in extent, degree of priority, or otherwise) as in law it may attach;[1]

(b) Since only a part of the cost of the land acquired for the Northern California Extension was financed by the use of First Mortgage Bonds or deposited cash, the First Mortgage is a lien only on such portions of the Northern California Extension as were financed by the use of First Mortgage Bonds or deposited cash; the Refunding Mortgage is a first lien on any portions of the Northern California Extension not so financed;[2]

(c) In the absence of a recorded supplemental indenture specifically describing the Northern California Extension, the notice imparted by the recording of the First Mortgage was insufficient to entitle the

[1] Brief of Refunding Mortgage Trustee, pp. 7, 41, 44-51.

[2] Brief of Refunding Mortgage Trustee, pp. 40, 43, 46-47.

First Mortgage to priority over the Refunding Mortgage on the entire Northern California Extension;[1]

(d) Those holders of Refunding Mortgage Bonds who participated in the financing of the Northern California Extension (the A. C. James Co. and Reconstruction Finance Corporation)[2] made their advances under such circumstances as to create in their favor liens on the Northern California Extension ranking *pari passu* with the lien of the First Mortgage.[3]

The first two contentions present alternative theories as to the relative priorities of the First Mortgage and the Refunding Mortgage. The theory of the first contention (which we may call the "undivided interest theory") is that the First Mortgage is in effect a lien on an undivided interest in the entire Northern California Extension. The theory of the second contention (which we may call the "separate segment theory") is that the Northern California Extension is divisible into bonded and unbonded segments, the bonded segments being subject to the lien of the First Mortgage and the unbonded segments being subject only to the lien of the Refunding Mortgage.

The third contention is apparently merely a subsidiary contention advanced in support of both the "undivided interest theory" and the "separate segment theory", but it can more conveniently be discussed as a separate proposition.

The theory of the fourth contention apparently is that the advances made by the A. C. James Co. and Reconstruction Finance Corporation are secured by equitable liens, analogous to purchase-money liens, entirely apart from the lien created by the Refunding Mortgage.

These four contentions will be discussed in order.

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[1] Brief of Refunding Mortgage Trustee, pp. 41, 43-44, 45.

[2] The Railroad Credit Corporation did not participate in the financing.

[3] Brief of Refunding Mortgage Trustee, pp. 41, 48-51.

(I). The Granting Clauses of the First Mortgage Cover in Its Entirety an Extension Financed in Any Part with First Mortgage Bonds or Deposited Cash; the Lien Thus Created Is Not Limited, Either in Extent or Priority, to the Amount of First Mortgage Bonds or Deposited Cash Used in Such Financing.

There can be no question but that, as regards California property, a mortgage of after-acquired property, duly recorded, is effective against creditors and subsequent encumbrancers.

Section 2883 of the Civil Code of California[1] provides as follows:

> "§ 2883. *Lien on future interest.* An agreement may be made to create a lien upon property not yet acquired by the party agreeing to give the lien, or not yet in existence. In such case the lien agreed for attaches from the time when the party agreeing to give it acquires an interest in the thing, to the extent of such interest."

Section 2930 of the Civil Code of California[2] provides as follows:

> "§ 2930. [*Subsequently acquired title inures to mortgagee.*] Title acquired by the mortgagor subsequent to the execution of the mortgage, inures to the mortgagee as security for the debt in like manner as if acquired before the execution."

See:

California Title Insurance & Trust Co. v. *Pauly*, 111 Cal. 122, 43 Pac. 586 (Cal., 1896);

Mason v. *Citizens' Nat. Trust & Savings Bank of Los Angeles*, 71 F. (2d) 246 (C. C. A., 9th Circ., 1934).

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[1] Cal. Civ. Code (Deering, 1941) § 2883.

[2] Cal. Civ. Code (Deering, 1941) § 2930.

The question here is solely one of interpretation of the after-acquired property clauses of the First Mortgage.

THE GRANTING CLAUSES OF THE FIRST MORTGAGE.

Granting Clause Third[1] of the First Mortgage covers, *inter alia*:

> "Any and all * * * extensions * * * which may from time to time hereafter be acquired or constructed by or belong to the Company * * * if
>
> "(a) acquired or constructed by the use of First Mortgage Bonds or proceeds thereof or cash deposited hereunder (except bonds delivered or cash paid out under any of the provisions of this indenture in reimbursement of previous expenditures certified as hereinafter provided) *or on account of the purchase, acquisition or construction thereof or work thereon* First Mortgage Bonds shall hereafter be authenticated and delivered or the proceeds of First Mortgage Bonds or other cash deposited hereunder shall hereafter be paid out under any of the provisions of this indenture; * * *."

It is significant that the qualifying proviso in subparagraph (a) is stated in the alternative: an after-acquired extension falls within the scope of the after-acquired property clause, if either (1) the extension be "acquired or constructed" by the use of First Mortgage Bonds or deposited cash, or (2) First Mortgage Bonds or deposited cash be taken down "on account of the purchase, acquisition or construction thereof or work thereon."

The difference between the two alternatives is apparent from the words used. The first alternative must contemplate a financing entirely by the use of First Mortgage Bonds or deposited cash; the second alternative, with the words "on account of", and the words "or work thereon", must contemplate a financing in part by such means. In either case, the extension falls within the scope of the after-acquired property clause, and there is no language

[1] Appendix A, *infra*, pp. 110-111.

which suggests an intent that the lien of the First Mortgage should attach to an extension financed in part by the use of First Mortgage Bonds or deposited cash to a lesser extent than would be the case if the extension were financed entirely by such means.

The "undivided interest theory" is based primarily upon the "free funds" provision,[1] which reads in part as follows:

> "But nothing express or implied in this indenture shall be construed to limit the right or power of the Company or any successor or purchasing corporation, which right and power is hereby expressly reserved, by the use of its credit or free funds or by the use of First Mortgage Bonds delivered to the Company or any successor or purchasing corporation as in this indenture provided to reimburse the Company or any such successor or purchasing corporation for expenditures theretofore actually made out of its free funds, to construct or acquire free from the lien hereof lines of railroad, extensions or branches or interests therein, * * * *provided the same shall not be* lines of railroad, extensions, or branches or interests therein, * * * (a) *on account of the purchase, acquisition or construction whereof or work whereon* First Mortgage Bonds shall be authenticated and delivered or their proceeds or other cash deposited hereunder shall be paid out as herein provided; * * *."

But the right reserved, viz., to acquire property free of the lien, is strictly limited by the language of the proviso, which is to the effect that such property shall not be property "on account of the purchase, acquisition or construction whereof or work whereon" First Mortgage Bonds or deposited cash shall be taken down. The language of the proviso in the "free funds" provision is substantially identical with the language in the after-acquired property clause—the "free funds" provision and the after-acquired property clause are parallel and complementary. The right to acquire an extension free of the lien stops at the

[1] Appendix A, *infra*, pp. 113-114.

point where the after-acquired property clause begins, namely, the point at which First Mortgage Bonds or deposited cash are used to finance in any part the purchase, acquisition or construction of such extension or any work thereon.

Construing the "free funds" provision in the light of the after-acquired property clause in Granting Clause Third, it is apparent that an after-acquired extension becomes subject in its entirety to the lien of the First Mortgage if financed either in whole or in part with First Mortgage Bonds or deposited cash and that the lien thus created is not limited, either in extent or in priority, to the amount of First Mortgage Bonds or deposited cash used in such financing.

The Bond and Cash Takedown Provisions.

That this is the correct interpretation is further indicated by the provisions of Section 2 of Article Second,[1] which specify the conditions upon which bonds and deposited cash may be taken down in respect of the acquisition of property. These provisions permit the bonding of property, although only a portion of its entire cost be used as the basis for the takedown of bonds or deposited cash;[2] but these provisions require that the entire interest acquired by the Debtor in the property bonded shall be subjected to the lien of the First Mortgage, and do not permit any part of the interest acquired by the Debtor to be kept out of the lien of the First Mortgage and pledged to some other party.[3] Furthermore, they con-

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[1] J. C. C. Exhibit No. 5, pp. 40-60.

[2] Although this is apparent from a reading of the bond and cash takedown provisions as a whole, the provisions of clause (f) on page 43 will serve as a specific illustration. Clause (f) permits bonds or deposited cash to be taken down to reimburse the Debtor "*in whole or in part* for money expended by it after June 30, 1916, for any one or more of the purposes enumerated in clauses (a), (b), (c), (d) and (e) of this subsection A".

[3] Paragraph Sixth, on pages 54-55, requires the delivery to the First Mortgage Trustees, in case bonds or deposited cash are taken down "with respect to the construction or acquisition of *any prop-*

template that the First Mortgage shall be in effect a first lien on the property bonded; the only outstanding prior encumbrances permitted are certain excepted encumbrances,[1] such as charges ordinarily incident to construction, which are treated as *de minimis*, and liens existing at the time of acquisition, which are required to be certified at the time of the bonding and which are required to be taken care of by reserving bonds or deposited cash. The curious encumbrance contended for by the Refunding Mortgage Trustee is not one of the excepted encumbrances or certified liens.

Since the First Mortgage requires that the Debtor's entire interest in all property bonded shall be subject to the lien, the words "on account of the purchase, acquisition or construction thereof or work thereon" in Granting Clause Third,[2] and the words "on account of the purchase, acquisition or construction whereof or work whereon" in the "free funds" provision,[3] would seem to be meaningless and to serve no useful purpose, unless these provisions be construed as causing the lien of the First Mortgage to attach to the Debtor's entire interest in after-acquired extensions, if the purchase, acquisition

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erty", of (a) evidence of the execution and delivery to the Debtor of "all deeds, conveyances or other instruments necessary to vest the title to *such property*" in the Debtor, subject only to excepted encumbrances and certified liens, (b) "all supplemental indentures or instruments of further assurance necessary to subject *any such property acquired*" by the Debtor to the lien of the First Mortgage, subject only to excepted encumbrances and certified liens, and (c) an opinion of counsel to the effect that the instruments delivered as called for by clauses (a) and (b) are sufficient for the purposes above specified or that no such instrument is necessary for either or both of said purposes.

[1] The excepted encumbrances include (p. 50): (1) necessarily undetermined liens or charges ordinarily incident to construction or operation and current indebtedness arising from operation for a period not exceeding six months, (2) the lien of the First Mortgage, (3) liens subordinate to the lien of the First Mortgage, (4) liens pledged under the First Mortgage, and (5) liens previously certified against which bonds or deposited cash have already been reserved.

[2] Appendix A, *infra*, p. 110.

[3] Appendix A, *infra*, p. 114.

or construction thereof, or any work thereon, be financed in any part with First Mortgage Bonds or deposited cash.

THE SUBORDINATION COVENANT.

Further evidence of the correctness of this interpretation is found in the covenant contained in Section 13 of Article Fourth of the First Mortgage,[1] which reads as follows:

> "In case the Company shall hereafter mortgage any of the property which is, or by the terms hereof purports to be or which is intended to become, subject hereto, such mortgage shall be, and shall be expressed to be, subject to the prior lien of this indenture for the security of all First Mortgage Bonds then or thereafter to be outstanding hereunder."

In the face of this covenant, it is impossible to construe the after-acquired property clauses of the First Mortgage as creating a lien ranking merely *pari passu* with the lien of a subsequently executed mortgage on property financed only in part with First Mortgage Bonds or deposited cash. If the lien of the First Mortgage attaches at all to the property, it clearly attaches as a first lien upon the Debtor's entire interest in the property and is prior in every respect to the lien of the subsequently executed mortgage.

Such a result is not inequitable, as contended by the Refunding Mortgage Trustee.[2] The terms of the mortgage contract are perfectly clear. They impose a condition upon the right of the Debtor to take down bonds or deposited cash. The Debtor is not obliged to finance any part of the cost of new property with First Mortgage Bonds or deposited cash, but, if it chooses to do so, the First Mortgage requires that its entire interest in the property bonded be subjected to the lien. If the Debtor wishes to acquire

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[1] I. C. C. Exhibit No. 5, p. 79.

[2] Brief of Refunding Mortgage Trustee, pp. 48-49.

property free of the lien, it must finance it entirely outside of the First Mortgage.

As we have pointed out, the bond and cash takedown provisions of the First Mortgage evidence a purpose that the First Mortgage shall be in effect a first lien on all property bonded. The draftsman sought to accomplish that purpose by carefully providing that liens existing at the time of acquisition should be certified at the time of the bonding and that First Mortgage Bonds or deposited cash should be reserved against them. That purpose would be defeated if the Debtor were permitted at a later date to create all sorts of *pari passu* liens without reserving First Mortgage Bonds or deposited cash to take care of them.

The concept underlying the First Mortgage is not a concept of undivided interests in separate pieces of property standing as security for separate parts of the debt, but a concept of the mortgaged enterprise as a whole standing as security for the debt as a whole.

(II) The Northern California Extension Cannot Be Divided into Bonded and Unbonded Segments.

The "separate segment theory" is based principally upon the fact that the cash requisitions under the First Mortgage in connection with the Northern California Extension include only $197,075.73 of expenditures for "land for transportation purposes",[1] whereas the total amount spent from all sources for "land for transportation pur-

[1] There is nothing in the record to indicate that these expenditures can be allocated to any particular portion of the land acquired. It is logical to assume that the expenditures certified represent merely a proportionate amount of the aggregate cost of all of the land acquired. This is consistent with the scheme of financing outlined in Sections 1 and 2 of Article II (pp. 16-19) of the Indenture dated July 1, 1930 (I. C. C. Exhibit No. 50, R. 2327, 2335), which contemplated that Debentures and First Mortgage Bonds would be used in approximately equal proportions to meet the cost of the Northern California Extension as the work went forward.

poses" in connection with the Northern California Extension was $504,590.66 (R. 1084). The argument is made, therefore, that the lien of the First Mortgage attached only to the land acquired with the proceeds of the First Mortgage Bonds.

This argument overlooks the fact that the cash requisitions under the First Mortgage included expenditures for other purposes in connection with the construction of the Northern California Extension and that there is nothing in the record to indicate that these expenditures were made only upon land acquired with the proceeds of the First Mortgage Bonds. On the contrary, the evidence strongly indicates that the proceeds of the First Mortgage Bonds were applied indiscriminately over the entire line.

The officers' certificates included in the cash requisitions under the First Mortgage, in certifying that expenditures have been made, refer to the extension in its entirety (I. C. C. Exhibit No. 62, sheet 11, which is typical of all of the subsequent requisitions, R. 2368), and the itemizations of the expenditures made indicate that they were not confined to any particular sections of the line.

The first requisition, under which the proceeds of $1,000,000 principal amount of bonds were withdrawn on February 11, 1931, was based upon expenditures between February 1, 1929, and November 30, 1930, including items of engineering, land, grading, tunnels and subways (R. 1082). By December 31, 1930, a substantial part of the grading, tunneling and culvert installation, and practically all of the clearing, had been completed (R. 1077), so that it is a fair inference that the right of way for the entire line had by then been acquired and that the expenditures certified in the various cash requisitions under the First Mortgage were made over the entire line and not merely upon segments or sections of an incomplete right of way.

The large amounts of expenditures certified in the various cash requisitions for such purposes as engineering ($345,392.32), grading ($2,323,625.48), tunnels and subways ($561,053.14), and bridges, trestles and culverts

($868,830.53)[1] are a strong indication that the expenditures certified were not confined to land acquired with the proceeds of the First Mortgage Bonds, All of the expenditures certified in the cash requisitions were made prior to November 30, 1931,[2] and the last withdrawal of deposited cash under the First Mortgage was made on January 29, 1932, prior to the execution and delivery of the Refunding Mortgage, so that none of the expenditures certified could have been made on land to which the lien of the Refunding Mortgage had already attached (R. 1067, 1081-1083).

The bond and cash takedown provisions of the First Mortgage (clauses (a) and (f) of subsection A of Section 2 of Article Second[3]) permit the bonding of an extension only when it is "connecting with" a line of railroad owned by the Debtor and subject to the lien of the First Mortgage. Accordingly, the First Mortgage would not have permitted the Debtor to bond disconnected segments of the Northern California Extension. The fact that, in the cash requisitions, the Northern California Extension was described by its termini as a new line of railroad "to connect with the existing main line" of the Debtor indicates an inten-

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[1] The aggregate amounts of the expenditures for the various purposes specified in the cash requisitions are as follows (R. 1081-1083):

Land for Transportation Purposes	$. 197,075.73
Engineering	345,392.32
Grading	2,323,625.48
Tunnels and Subways	561,053.14
Bridges, Trestles and Culverts	868,830.53
Ties	137,701.78
Rails	61,168.41
Other Track Material	94,860.96
Ballast	191,778.07
Track Laying and Surfacing	162,784.18
Right-of-Way Fences	3,534.20
Crossings and Signs	6,254.56
Station and Office Buildings	1,206.98
Water Stations	13,844.32
Telegraph and Telephone Lines	14,461.63
Other Expenditures—Road	16,426.69

[2] Connection with the Great Northern Railway at Bieber was made on November 10, 1931, and freight service was then inaugurated under the jurisdiction of the construction department (R. 1077).

[3] I. C. C. Exhibit No. 5, pp. 41, 43.

tion to bond the extension as an entirety and not merely disconnected segments of the extension.

Even if it could be demonstrated that all of the expenditures certified were made on particular segments of the line and that there were other segments upon which no proceeds of the First Mortgage Bonds were expended, that fact would not prevent the lien of the First Mortgage from attaching to the entire Northern California Extension.

Granting Clause Third[1] of the First Mortgage covers, *inter alia*,

> "Any and all property and facilities * * * which may from time to time hereafter be acquired or constructed by or belong to the Company * * * if
>
> * * * * * *
>
> "(b) consisting of * * * property or facilities constituting *an integral part or parts* of * * * extensions * * * subject to the lien of this indenture *or some other integral portion whereof is or integral portions whereof are subject to the lien hereof* * * *."

Assuming that the Northern California Extension is divisible into bonded and unbonded segments, it is clear that each segment is an "integral part" of the extension. Inasmuch as the bonded segments are admittedly subject to the lien of the First Mortgage, the conclusion is inescapable that the unbonded segments are likewise subject to the lien of the First Mortgage, because they constitute integral parts of an extension of which other integral portions are subject to the lien of the First Mortgage.

(III) No Supplemental Indenture Was Necessary to Entitle the First Mortgage to Priority over the Refunding Mortgage on the Entire Northern California Extension.

The third contention of the Refunding Mortgage Trustee is that, in the absence of a recorded supplemental in-

[1] Appendix A, *infra*, pp. 110-111.

denture specifically describing the Northern California Extension, the notice imparted by the recording of the First Mortgage was insufficient to entitle the First Mortgage to priority over the Refunding Mortgage on the entire Northern California Extension.

This contention apparently is founded upon the argument that the descriptive language in the after-acquired property clauses of the First Mortgage is not sufficiently definite.

Under the test laid down by the California statutes and by the authorities, a description in a deed or mortgage is sufficiently definite if the property can be identified by extrinsic evidence.

Section 3538 of the Civil Code of California[1] provides as follows:

> "§ 3538. That is certain which can be made certain."

See:

California Title Insurance & Trust Co. v. *Pauly*, 111 Cal. 122, 43 Pac. 586 (Cal., 1896);

Higgins v. *Higgins*, 121 Cal. 487, 53 Pac. 1081 (Cal., 1898);

Hancock v. *Watson*, 18 Cal. 137, 140 (1861).

In the *Pauly* case, the court held that a mortgage of a street railway line, the granting clauses of which contained the language "and its real, personal, and mixed property, franchises, rights of way, privileges, interests, and appurtenances, of every kind and nature, that it now owns, or that it may hereafter acquire, for use, or adapted to use, on or about its said lines of railway" covered an after-acquired piece of land which, by parol evidence, was shown to have been acquired for use, and to be adapted to use, on or about the mortgaged lines. Counsel for the appellant objected to the admission of parol evidence to show that the property was of the character described in the granting clauses.

[1] Cal. Civ. Code (Deering, 1941) § 3538.

In holding that the evidence was admissible, the court said (p. 588 of 43 Pac.):

> "The purpose for which such evidence was introduced, and which it served, was to prove that the pavilion grounds were acquired by the railway company for use, and adapted to use, 'on or about its said lines of railway;' and thus to identify them as being after-acquired real estate described in the mortgage, or, as may be otherwise expressed, to apply to those grounds the description contained in the mortgage, though the description of itself is unambiguous and sufficiently certain. That parol evidence is competent for this purpose does not admit of a doubt. Greenl. Ev. § 287; Hancock *v.* Watson, 18 Cal. 137; Began *v.* O'Reilly, 32 Cal. 11; Marriner *v.* Dennison, 78 Cal. 202, 20 Pac. 386; Towle *v.* Coal Co., 99 Cal. 397, 33 Pac. 1126."

Section 19 of the Civil Code of California[1] provides as follows:

> "§ 19. *Constructive notice, when deemed.* Every person who has actual notice of circumstances sufficient to put a prudent man upon inquiry as to a particular fact, has constructive notice of the fact itself in all cases in which, by prosecuting such inquiry, he might have learned such fact."

The law is well settled that a description in a mortgage sufficient to put a subsequent purchaser or encumbrancer upon inquiry as to the property intended to be conveyed is constructive notice of the effect of the recorded instrument.

8 Thompson, Real Property (Perm. Ed. 1939), § 4338;

Vercruysse v. *Williams*, 112 Fed. 206 (C. C. A., 8th Circ., 1901).

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[1] Cal. Civ. Code (Deering, 1941) § 19.

The First Mortgage was recorded in the counties in which the Northern California Extension is situate in 1916 (R. 1066-1067). The Refunding Mortgage, by the provisions appearing on page 23 of I. C. C. Exhibit No. 6, is made expressly subject to the lien of the First Mortgage. Aside from the notice thus imparted, we do not believe it can be seriously contended, on the facts disclosed in the record in this proceeding, that the holders of Refunding Mortgage Bonds did not have at least constructive, if not actual, notice as to the lien of the First Mortgage on the Northern California Extension.

(IV) The Advances by A. C. James Co. and Reconstruction Finance Corporation Were Not Made Under Such Circumstances as to Create Liens on the Northern California Extension in Favor of Either.

The doctrine under which parties making advances for the acquisition or construction of property may, under certain circumstances, become entitled to liens on the property prior to the lien of an existing mortgage containing an after-acquired property clause is well known to equity. But the authorities which establish the doctrine also prescribe certain essential requirements which must be met. In the case of the advances made by the A. C. James Co. and Reconstruction Finance Corporation, as will be shown, these requirements were not met.

In an effort to escape the inexorable conclusion to which these authorities lead, the Refunding Mortgage Trustee insists that it is claiming, not prior liens but merely *pari passu* liens.[1] But we know of no other doctrine, legal or equitable, under which parties making such advances can obtain either priority over or parity with the lien of an existing mortgage with an after-acquired property clause:

[1] Brief of Refunding Mortgage Trustee, pp. 49-51.

The case of *Citizens' Savings & Trust Co.* v. *Cincinnati & D. Traction Co.*, 106 Ohio St. 577, 140 N. E. 380 (Ohio, 1922), cited by the Refunding Mortgage Trustee, is so clearly not in point that it scarcely merits discussion.

In that case, each of the three divisional mortgages covered a power plant. When the consolidated company discontinued these separate power plants, it took away part of the security of each of the divisional mortgages, which it then became under an equitable duty to restore. This it did in effect by building a central power plant. But, since the court could not divide the central power plant into three parts and give one part to each of the three divisional mortgages, it did the only thing which a court of equity could do under the circumstances—it gave to each a *pari passu* lien on an undivided interest in the whole. There is no analogy between the situation in that case and the situation of a creditor seeking to displace the lien of an existing mortgage.

The Two Requirements: Time and Intent.

The doctrine under which parties making advances for the acquisition or construction of property become entitled to liens on the property prior to the lien of an existing mortgage containing an after-acquired property clause is subject to two important requirements:

(1) The advances must have been made before or in substance at the very time of the coming of the property into the possession or ownership of the mortgagor, and

(2) An express agreement or intent to create a prior lien securing the advances must have been clearly evidenced.

The Authorities.

In *Harris* v. *Youngstown Bridge Co.*, 90 Fed. 322 (C. C. A., 6th Circ., 1898), the court, consisting of Circuit Judges Taft and Lurton and District Judge Clark, in

an opinion rendered by Judge TAFT, discussed and applied the doctrine.

In 1881, the Kentucky & Indiana Bridge Company made the "first mortgage" to secure $1,000,000 in principal amount of bonds; the "first mortgage" in terms covered the bridge and its approaches and all after-acquired property.

In 1886, after the "bridge and its main line" were completed, the Bridge Company, to secure a new tenant, agreed to connect the bridge with additional railroads and terminals and to replace the wooden approach by a steel structure. For the purpose, the Bridge Company made the "terminal trust deed" to Theodore Harris as trustee securing an issue of $400,000 in principal amount of bonds issued to the "contract company"; the "contract company" with its own funds purchased additional land and constructed tracks connecting the bridge with the additional railroads and terminals; the "contract company" acquired title to the land, either in its name or in the name of a trustee, and, after the partial completion of the tracks, conveyed the property to the Bridge Company.

The "terminal trust deed" bonds were held entitled to priority over the "first mortgage" bonds in respect of the additional land and tracks paid for by the "confract company".

The court, after mentioning vendor's liens, liens of purchase-money mortgages, rights of conditional vendors, and liens of unrecorded mortgages as examples of claims entitled to priority over the lien of a mortgage containing an after-acquired property clause, stated in general terms the rule that (p. 329), "where the legal or equitable title of the mortgagor ripens and is acquired only through the outlay or expenditure of another, under such circumstances that, as between the other and the mortgagor, the former has a lien in equity upon the interest of the latter, the prior mortgage with an after-acquired property clause attaches only to the interest of the mortgagor subject to the same lien".

For the general statement of the rule, the court cited *Bear Lake Irrigation Co.* v. *Garland*, 164 U. S. 1 (1896),

in which case this Court referred to the doctrine in the following terms (pp. 15-16):

> "On the contrary, the latter claim to bring their case within the rule recognized in this court, that even under the after-acquired property clause in a mortgage, if property be burdened with an incumbrance or lien at the very time of coming into the possession or ownership of the mortgagor, such incumbrance remains prior and superior to the lien of the mortgage, although it was actually subsequent thereto in point of time. * * *"

The Circuit Court of Appeals, after stating the general rule and citing the *Garland* case, then applied the general rule to the claim of the "contract company" (p. 329):

> "* * * Where, therefore, at the instance of the mortgagor, a third person pays the purchase money for additions, and takes title to them himself, or directs their conveyance directly to the mortgagor, with an express agreement that he shall have a lien for the purchase money, such lien is prior to that of the mortgagor, because it is only through his expenditure that the purchase is effected and the addition acquired. * * * So long as the lien asserted is for money used in good faith to acquire the very thing upon which the lien is claimed, we do not see how the first mortgagee is defrauded."

The court stated its conclusion that the "terminal trust deed" bonds were entitled to a prior lien as follows (p. 330):

> "* * * We are therefore of opinion that in the case before us all the rights of way which were purchased and paid for by the contract company, together with all the improvements placed thereon by that company, whether the rights of way were first put in the name of Harris, trustee, as the contract required they should be, before transfer to the bridge company, or were conveyed directly to the bridge company, without the interposition of Trabue or Harris, trustee, are subject to a lien in favor of Harris, trustee, for the bondholders, prior to that of the first mortgage. This

will include the two lots acquired by condemnation, for which the contract company paid the full purchase-price. The payment of the price was a condition precedent to the passing of any title at all, and the contract company, and Harris, trustee, for the bondholders, in thus effecting the purchase, are entitled to rely on the rights secured to them by their contract with the bridge company."

The court, however, took a distinction as to the rights of way not paid for by the "contract company" but apparently constituting essential parts of the addition acquired through the "terminal trust deed" transaction (pp. 331-332):

"What has been said applies only to the private property bought by the contract company with its money. With respect to the rights of way obtained by ordinances from the city of Louisville and the village of Parkland, the case is different. The contract company paid nothing for these rights of way, and contributed nothing to their acquisition. Therefore they came into the possession and enjoyment of the bridge company burdened with no lien except such as might arise from the improvement of that which was already the property of the bridge company. * * *

It follows that the lien given by the after-acquired property clause of the first mortgage attached to the rights of way in the streets immediately upon the passage of the ordinances, and that improvements upon the rights of way only increased the security by becoming part of the realty. The lien asserted by Harris, trustee, on this part of the terminals, did not arise in the act of acquisition, but only in the improvement after acquisition. * * *

"It remains to consider those cases in which the land for rights of way was given for a nominal consideration to the bridge company. It is impossible to distinguish them from the rights of way granted by ordinance; The title to the land passed to the bridge company, and the improvements constructed thereon became a part of the realty of that company, to which

the lien of the first mortgage attached the moment the title to the land passed to the company. The lien of Harris, trustee, upon such lands, must therefore be postponed to that of the first mortgage.

"The result is that the lien of the terminal trust bondholders upon the new terminals is, as to that part situate upon real estate or rights of way for which the contract company paid, prior in right to the lien of the first mortgage, to the extent of the sums expended in buying the lands or easements, and in erecting the necessary structures thereon, but that as to the remainder of the new terminals their lien is junior to that of the first mortgage."

A separate claim was made by the Columbia Finance & Trust Company and sustained by the court.

Some land was bought and a new steel approach substituted for the old wooden approach with funds borrowed from the Trust Company, under a contract (which expressly provided for a lien to secure the Trust Company [p. 334])[1] pursuant to which the Trust Company pur-

[1] The Transcript of the Record on Appeal in that case (pp. 97, 98 and 99) shows the contract contained the following provisions in addition to those quoted in the opinion at page 334:

"Whereas * * * the Trust Company is willing to advance the money for the purchase of said lots of land, and the Bridge Company expects to obtain other persons, as friends of the company, to advance to or for it the means necessary to pay for the labor or material * * * but said persons will not be willing to advance said money unless secured therein in manner and form as herein set forth; and

* * * * *

"III

"All of the ground so to be conveyed to the Trust Company, together with the entire railroad to be constructed thereon, and all the material embraced therein, shall be held by it in trust as follows:

"First. To secure to the said Trust Company the payment by the Bridge Company of all sums of money which it may have advanced for the purchase of said tracts of ground above mentioned, * * *. And for any unpaid residue the said Trust Company shall have the right by legal proceedings to cause a sale of the entire ground occupied by said railroad and said railroad itself."

chased with its own funds the rights of way and took title in its own name and thereafter conveyed title to the Bridge Company. The court held that the Trust Company was entitled to a first lien on the property so purchased to secure the amount of the advances and the consequential damages and compensation provided for pursuant to the contract.

An additional claim was made by indorsers of notes of the Bridge Company sold to obtain funds for the construction of the new steel approach. The claim was for a prior lien to secure the amounts which the indorsers had been required to pay to discharge their liabilities as indorsers. The claim was rejected.

The court pointed out (p. 334) that the funds obtained appeared to have been turned in to the general account of the Bridge Company and that the testimony merely showed an amount equal to the funds so obtained was at some time expended on the construction of the new steel approach. The court said (p. 334):

> "* * * The after-acquired property clause in a mortgage does not displace any equitable lien which really grows out of the act of acquisition, by purchase or otherwise, so that the mortgagor may be properly said to acquire the property with the lien on it, or less the lien. It is not infrequently a nice question to decide whether the lien really inheres in the act of acquisition, or whether it is given the false appearance of doing so at the instance of the purchaser, for the purpose of evading an after-acquired property clause in a prior mortgage, and is really nothing more than a lien taking effect after the act of acquisition, and not as part of it, and is thus subordinate to the mortgage. * * * The creditors sought to be secured were the creditors of the bridge company. They loaned their credit to the bridge company to enable it to borrow money to build its own bridge. The bridge company secured to them a lien on its equitable interest in the land bought for it by the Columbia Trust Company, after it should have paid the purchase price to the trust company. To that equitable interest the lien

of the first mortgage attaches the moment the purchase money is paid. As the learned judge of the circuit well said, 'The interest which was thus made subject to these advances was the interest of the bridge company, and not the title or interest of the trust company.' The lien of Gaulbert and others upon the new approach is therefore subordinate to the lien of the first mortgage."

The court rejected the claim of the indorsers even though an agreement, which was put in evidence and quoted in part in the opinion (p. 334), expressly provided for a lien to secure "moneys raised upon notes or other obligations upon which individuals may have become bound for the bridge company, as indorsers, guarantors, accommodation makers, or otherwise".

The doctrine discussed and applied in the *Harris* case was also discussed and applied, with particular stress upon the necessity of an express agreement or intent to create a prior lien securing the advances, in *Shooters Island S. Co.* v. *Standard Shipbuilding Corp.*, 293 Fed. 706 (C. C. A., 3rd Circ., 1923).

In 1915, the Standard Shipbuilding Corporation made a mortgage in the amount of $863,000 to secure the purchase price of premises constituting a shipbuilding plant; the mortgage in terms covered the premises "'And all additions and extensions to said real property, including any and all rights to lands under water adjoining said premises' * * *". In 1917, a supplemental mortgage was given, pursuant to the covenant of further assurance in the mortgage, covering a leasehold interest (in land under water) acquired by the Shipbuilding Corporation after the execution of the mortgage; the lease contained an option to purchase the fee.

Subsequent to the execution of the supplemental mortgage, the United States Shipping Board Emergency Fleet Corporation, following the requisitioning of all ships under construction in the Shipbuilding Corporation's plant, made various advances to the Shipbuilding Corporation, includ-

ing an advance of more than $5,000,000 for additions and improvements to the plant. The court pointed out (p. 709) that this advance was made without demanding security and, so far as the record in the case showed, without a move to question or disturb the lien of the mortgage upon the after-acquired properties.

The advance of more than $5,000,000 was used, among other things, for the purchase (pursuant to the option) of the fee to the land a leasehold interest in which was covered by the supplemental mortgage.

In 1920, the Shipbuilding Corporation and the Emergency Fleet Corporation made a contract adjusting their accounts, which found the sum of $1,337,000 to be due to the Emergency Fleet Corporation. The Shipbuilding Corporation delivered bonds for this amount secured by a mortgage on the plant; the mortgage was executed pursuant to an agreement which provided that the mortgage should be subject to the existing mortgage for $863,000. The court pointed out (p. 710) there could be no doubt that, at the time of the execution of the mortgage to the Emergency Fleet Corporation, it had no other thought than that it was obtaining a mortgage whose lien was subject to the prior lien of the $863,000 mortgage.

In 1922, in connection with suits to foreclose the two mortgages, the Emergency Fleet Corporation claimed, for the first time, a prior lien on the fee to the land purchased with the money advanced by the Emergency Fleet Corporation (and the improvements made to said land with money so advanced).

In rejecting the claim to priority, the court said (pp. 713-714):

> "The claimed equitable lien, therefore, rests on the single fact that money which the Fleet Corporation loaned or advanced to the Shipbuilding Corporation under shipping contracts was used in the purchase and improvement of the land. That the Fleet Corporation intended it to be so used is evidenced by the warrant issued for the money and its expenditure, * * *. Unless we are to hold that such expenditures, singly

and alone, create in each instance, wherever applied and expended, an equitable lien in favor of the party advancing the money, thereby divesting rights held under an existing mortgage, we are constrained to hold that the purchase of lands from the State of New Jersey and the building of ways thereon with moneys which the Fleet Corporation either loaned or advanced to the Shipbuilding Corporation do not, without more, give it an equitable lien on the properties so purchased and improved. We freely admit that under different circumstances an equitable lien could have been created which would have displaced the lien of the prior mortgage under its after-acquired property clause. But under the circumstances as they were, we are unable to find, either on authority or principle, that the rights of one silently and unconditionally loaning money for the purchase and improvement of property are superior to the rights of a party who holds the lien of a prior mortgage against the property.

. . . . .

"[5] We come to this conclusion not on the theory of estoppel of or waiver by the Fleet Corporation in adjusting its differences with the Shipbuilding Corporation in 1922 and accepting a second mortgage in settlement, as urged by the Shooters Island Company, although there is substance in this contention, Griffin *v.* Smith, 143 Fed. 865, 75 C. C. A. 73, but on the ground that where the evidence shows nothing, expressly or impliedly, was demanded or promised by either party, an equitable lien is not raised by the mere loaning and application of money for purchases and improvements that were understood and intended.

"[6] Passing from its alternative claims to legal and equitable liens, the Fleet Corporation next maintains that, having supplied the purchase money for the after-acquired property, its mortgage is a purchase money mortgage on the principle that an instrument may be a purchase money mortgage although given to a third person to secure money advanced by him. There is ample authority for this proposition. But even in such a situation the mortgage must be given for the purpose and with the intention of

securing the purchase money and, without regard to the date, it must be a part of one continuous transaction. New Jersey Building Loan & Investment Co. *v.* Bachelor, 54 N. J. Eq. 600, 35 Atl. 745; Stewart *v.* Smith, 36 Minn. 82, 30 N. W. 430, 1 Am. St. Rep. 651. Here the mortgage was given the Fleet Corporation five years after the money was advanced and there is nothing to show an agreement that, at the time of the advance, repayment was to be secured by the mortgage. It is, of course, not necessary that a deed and mortgage should be executed at the same hour, or even on the same day, provided, as the authorities say,

> 'the execution of the two instruments constitute part of one continuous transaction and were so intended. But where the mortgage is not executed until a considerable time after the deed, they cannot be construed as simultaneous and the mortgage will be postponed to intervening valid liens.' 1 Jones on Mortgages, § 469; Bridges *v.* Cooper, 98 Tenn. 381, 39 S. W. 720."

THE REQUIREMENT AS TO TIME WAS NOT MET.

As we have pointed out, the Debtor commenced making expenditures in connection with the Northern California Extension as early as February 1, 1929 (R. 1082). Actual construction work was commenced on August 16, 1930, and, by the end of 1930, practically all of the clearing and a substantial part of the construction work for the entire line had been completed (R. 1077), so that presumably the entire right of way had been acquired. By February 1, 1931, a total of $1,682,298.18 had been expended by the Debtor (I. C. C. Exhibit No. 95, sheet 10, R. 2464), before a single dollar had been advanced by either the A. C. James Co. or Reconstruction Finance Corporation.

On February 11, 1931, the first $1,000,000 principal amount of First Mortgage Bonds was authenticated and delivered and their cash proceeds withdrawn to reimburse the Debtor for the expenditures made up to November 30, 1930 (R. 1080-1082), and the lien of the First Mortgage

attached, by virtue of the after-acquired property clauses, to the line as it then existed.

The bid of the A. C. James Co. for the $5,000,000 principal amount of Debentures (I. C. C. Exhibit No. 49, R. 2327) was dated January 22, 1931, but the first $1,000,000 principal amount of Debentures was not authenticated and delivered until February 27, 1931 (R. 1084-1085).

Thus, the Northern California Extension had come into existence as a continuous right of way, with substantial improvements, owned by the Debtor, before a single dollar was advanced by the A. C. James Co.

Consequently, to use the language of Judge TAFT quoted at page 85 of this brief, the property "came into the possession and enjoyment of the * * * company burdened with no lien except such as might arise from the improvement of that which was already the property of the * * * company", and that property and the improvement were subject to the lien of the First Mortgage as a first lien. The liens claimed "did not arise in the act of acquisition, but only in the improvement after acquisition."

As indicated by the officers' certificates included in the cash requisitions under the First Mortgage, the expenditures made subsequent to February 27, 1931, were made chiefly for improvements to the real property constituting the right of way (R. 1081-1083), so that, even to the extent financed by the subsequent advances made by the A. C. James Co., the "improvements upon the rights of way only increased the security by becoming part of the realty" covered by the First Mortgage as a first lien,—to use the language of Judge TAFT quoted on page 85 of this brief.

The same is true of the advances made by the Reconstruction Finance Corporation, which were made between March 1 and August 1, 1932 (R. 1088), by which time the Northern California Extension was nearly completed and had already been placed in operation for freight service under the jurisdiction of the construction department (R. 1077). As shown by the applications submitted by the

Debtor to Reconstruction Finance Corporation, the advances were made entirely for the purpose of financing improvements to the already existing line (I. C. C. Exhibit No. 82, sheet 6 and Schedule P, R. 2449, 2451; I. C. C. Exhibit No. 87, pp. 3-5 and Schedule P, R. 2456).

Thus an examination of the record discloses a complete failure to meet the requirement that advances must be made before or in substance at the very time of the coming of the property into the possession or ownership of the mortgagor in order to cause such advances to be entitled to a lien on the property prior to the lien of a mortgage containing an after-acquired property clause.

THE REQUIREMENT AS TO INTENT WAS NOT MET.

Furthermore, an examination of the record discloses a complete failure to meet the requirement that an express agreement or intent to create a prior lien securing the advances must have been clearly evidenced.

The record contains no indication that either the A. C. James Co. or Reconstruction Finance Corporation had any intention that their advances when made would be secured by a prior lien on the Northern California Extension; the record indicates the opposite, namely, an intention or understanding that the Northern California Extension would be subject to the lien of the First Mortgage as a first lien.

The original offer of the A. C. James Co., dated May 14, 1929, stipulated that the advances should be secured by a first lien upon the Northern California Extension (I. C. C. Exhibit No. 45, R. 2308, 2316), but this offer was withdrawn and a new offer substituted, under date of June 19, 1929, which stipulated that the loan should be evidenced by unsecured debentures (I. C. C. Exhibit No. 46, R. 2319).

The specifications on the basis of which the A. C. James Co. purchased the Debentures issued under the Indenture dated July 1, 1930, stated in effect that the First Mortgage would constitute a first lien on the Northern California Extension (I. C. C. Exhibit No. 48, sheet 5, R. 2326). A

similar statement appeared in the specifications upon the basis of which The Western Pacific Railroad Corporation (of which Mr. A. C. James was a director) purchased the $5,000,000 principal amount of First Mortgage Bonds which were issued to finance in part the construction of the new extension (I. C. C. Exhibit No. 93, sheet 2, R. 2459; R. 1079-1080).

The resolutions adopted by the Executive Committee of the Debtor (Mr. James being a member of the Executive Committee and being present at the meetings at which those resolutions were adopted), and the opinions of counsel which the Debtor furnished to the First Mortgage Trustees in applying for the withdrawal of the cash proceeds of the First Mortgage Bonds showed that the Debtor regarded the entire Northern California Extension as being subject to the lien of the First Mortgage (I. C. C. Exhibit No. 86, R. 2455; I. C. C. Exhibit No. 62, sheets 8-9, R. 2368). In view of the close relationship of Mr. James to the Debtor, these formal expressions of the position of the Debtor indicate to an important extent the intention or understanding of Mr. James.

That intention or understanding is further indicated by the following statement appearing at page 6 of the petition of the A. C. James Co. for leave to intervene in the proceeding before the Commission (R. 2194, 2196):[1]

> "During the depression, the Northern California Extension, now recognized in any estimate of the future earning power of the road to be a factor of great importance, was built under the lien of the First Mortgage. Approximately $7,000,000 was advanced for the purpose by your petitioner, upon evidences of debt which were junior to the First Mortgage. The security held for the benefit of the First Mortgage bondholders was thus improved during the depression years."

The record shows that the intention or understanding of Reconstruction Finance Corporation also was that the

[1] This petition was not printed.

First Mortgage would constitute a first lien on the Northern California Extension. The applications made by the Debtor to Reconstruction Finance Corporation for loans to be secured by the pledge of Refunding Mortgage Bonds in effect stated that the lien securing the Refunding Mortgage Bonds would be junior to the lien of the First Mortgage on all of the properties of the Debtor except certain securities (I. C. C. Exhibit No. 82, sheet 7, R. 2449, 2451; I. C. C. Exhibit No. 87, p. 15, R. 2456).

POINT IV.

THE FIRST MORTGAGE IS A FIRST LIEN ON THE SO-CALLED "NONCARRIER" PROPERTY.

A. FACTS.

The Debtor's Account No. 705, entitled "Miscellaneous Physical Property", at December 31, 1935, contained certain items described as being property for "noncarrier" purposes (R. 1090-1091, and Exhibit H to the Stipulation,[1] p. 1, R. 1299). We understand that the claims with respect to "noncarrier" property asserted by the Refunding Mortgage Trustee are limited to the six items appearing in Lines 41, 66, 86, 105, 123, and 151.[2]

The only one of these items specifically mentioned in the brief of the Refunding Mortgage Trustee is the item appearing in Line 123. This item consists of numerous parcels of land in the Islais Creek District of San Francisco, which are shown in detail on the maps and schedules annexed to Exhibit H to the Stipulation. An analysis of these maps and schedules shows that by far the greater part of this property was acquired by the Debtor from its predecessor, Western Pacific Railway Company. All of the property acquired by the Debtor subsequent to the

[1] This exhibit was not printed.

[2] Stip., Exhibit H, p. 1, and Brief of Refunding Mortgage Trustee, p. 51.

execution and delivery of the First Mortgage was either acquired by the use of deposited cash under the First Mortgage or was acquired in exchange for property of the Debtor which was released from the lien of the First Mortgage, with the exception of two parcels of an aggregate book cost of approximately $7,000, which were acquired in 1932.[1] These two parcels, which are shown on Map "B", and on sheet 1 of Schedule B annexed to Exhibit H, as I. C. C. Parcels Nos. 253-A and 261-A, are situate in the area west of Illinois Street. They were acquired for industrial sites and trackage necessary to serve future industries (R. 1299-1300) and were originally carried on the books of the Debtor as "carrier" property (Stip., Exhibit H, p. 4).

The remaining items consist of (1) land in Oakland and Sacramento, California, all of which was either acquired by the Debtor from its predecessor, Western Pacific Railway Company, or was acquired by the use of deposited cash under the First Mortgage, and (2) land of negligible value acquired subsequent to the execution and delivery of the First Mortgage for use as gravel pits, none of which was acquired by the use of First Mortgage Bonds or deposited cash (Stip., Exhibit H, pp. 2-3).

The items appearing in Lines 86, 105 and 123 were originally carried on the Debtor's books in Account No. 701, entitled "Investment in Road and Equipment", and were subsequently transferred to Account No. 705, entitled "Miscellaneous Physical Property" (Stip., Exhibit H, p. 1).

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[1] Exhibit H to the Stipulation (pp. 5-6) clearly shows that some of the Islais Creek property was acquired subsequent to the execution and delivery of the First Mortgage and was acquired by the use of deposited cash under the First Mortgage. We understand the statement on page 52 of the brief of the Refunding Mortgage Trustee, that "The properties in dispute * * * were not acquired from proceeds of First Mortgage Bonds", to mean that the claims of the Refunding Mortgage Trustee are limited to that portion of the property which was not acquired by the use of deposited cash under the First Mortgage.

B. ARGUMENT.

All of the above described items of so-called "noncarrier" property fall within one or the other of two general classes, namely, (1) property acquired by the Debtor from its predecessor, Western Pacific Railway Company, and owned by the Debtor at the date of the execution and delivery of the First Mortgage, and (2) property acquired by the Debtor subsequent to the execution and delivery of the First Mortgage.

The brief of the Refunding Mortgage Trustee does not make clear whether the Refunding Mortgage Trustee is asserting its claims with respect to both classes of property or only with respect to property in the first class. Although the statement of facts in the brief (pp. 51-52) contains language indicating that the Refunding Mortgage Trustee may be asserting its claims with respect to property in both classes, the argument in the brief (pp. 53-55) deals only with "noncarrier" real estate acquired by the Debtor from its predecessor, Western Pacific Railway Company, and owned by the Debtor at the date of the execution and delivery of the First Mortgage. We shall therefore direct the argument in this brief primarily to property belonging in that class.

We do not believe that any valid contention can be made that the "noncarrier" property acquired by the Debtor subsequent to the execution and delivery of the First Mortgage is not subject to the First Mortgage as a first lien.

That portion of the after-acquired "noncarrier" property which was acquired by the use of deposited cash is subject to the lien of the First Mortgage by reason of the provisions of Granting Clause Third.[1]

That portion of the after-acquired "noncarrier" property which was acquired in exchange for property released from the lien of the First Mortgage is subject to the lien of the First Mortgage by reason of the provisions appearing in the last sentence of Section 8 of Article Seventh.[2]

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[1] Appendix A, *infra*, pp. 110-111.

[2] I. C. C. Exhibit No. 5, p. 115.

The two after-acquired parcels in the Islais Creek District of San Francisco which were acquired for industrial sites and trackage necessary to serve future industries are subject to the lien of the First Mortgage for the reason that they are property "acquired for use in or for the maintenance or operation" of the mortgaged lines (Granting Clause Third[1]) and are property "held for use * * * to facilitate * * * the maintenance or operation" of the mortgaged lines (Granting Clause Fifth[2]). The acquisition of land to be held for future sale to industries for the construction of plants and warehouses is an important and useful means of increasing the traffic and revenues of a railroad. An analogous situation was considered by the Supreme Court of California in *California Title Insurance & Trust Co.* v. *Pauly*, 111 Cal. 122, 43 Pac. 586 (Cal., 1896); see also *People's Trust Co.* v. *Schenck*, 195 N. Y. 398, 88 N. E. 647 (N. Y., 1909).

The three gravel pit properties are subject to the lien of the First Mortgage for a similar reason. A gravel pit is used by a railroad chiefly for the purpose of supplying material for ballast and other purposes in connection with the maintenance of the right of way.

The Refunding Mortgage Trustee contends, we understand, that the "noncarrier" real estate with respect to which it is asserting its claims is free of the lien of the First Mortgage and constitutes free assets against which the pledged holders of Refunding Mortgage Bonds are entitled to assert deficiency claims.[3]

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[1] Appendix A, *infra*, p. 110.

[2] Appendix A, *infra*, p. 112.

[3] Brief of Refunding Mortgage Trustee, pp. 53-55.

As pointed out in the answering brief of the Institutional Bondholders Committee (pp. 36-37), no deficiency claims can be asserted on the pledged Refunding Mortgage Bonds as such.

The cash and other current assets on hand at the date of the institution of the Section 77 proceedings, which the brief of the Refunding Mortgage Trustee (p. 8) mentions as being unmortgaged, are no longer available as a fund out of which the claims of creditors may be satisfied. Pursuant to orders of the District Court $10,000,000 in principal amount of prior lien trustees' certificates

(I) The Characterization of Property as "Noncarrier" Property in the Debtor's Accounts Does Not Affect the Scope of the Granting Clauses of the First Mortgage.

The fact that the Debtor, in accordance with the accounting regulations prescribed by the Interstate Commerce Commission, characterized certain property in its accounts as being for "noncarrier" purposes does not affect the scope of the granting clauses of the First Mortgage. The phrase would seem to have no other significance than as indicating that the property was not at the time actually being used for transportation purposes.

The granting clauses of the First Mortgage are not limited to property actually used for transportation purposes.

(II) The Granting Clauses of the First Mortgage Expressly Cover "Noncarrier" Real Estate Owned by the Debtor at the Date of the Execution and Delivery of the First Mortgage.

THE GRANTING CLAUSES OF THE FIRST MORTGAGE.

Granting Clause First of the First Mortgage[1] covers:

"All and singular the following described lines of railroad, terminals, lands, equipment, shares of stock

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have been issued to finance necessary maintenance expenditures in connection with the Debtor's three-year rehabilitation program (R. 1092-1093). Inasmuch as the District Court had no power to authorize the issuance of these trustees' certificates, except upon a showing that there were no funds available to finance the expenditures, it must follow that all of these current assets have been used up in the operation of the Debtor's railroad, to enable it to discharge its primary duty to the public to provide safe and efficient operation of transportation facilities required by the public interest. See: *Union Trust Co.* v. *Illinois Midland Co.*, 117 U. S. 434, 455-456 (1886); *International Trust Co.* v. *Decker Bros., et al.*, 152 Fed. 78 (C. C. A., 9th Circ., 1907); *Meyer* v. *Johnston*, 53 Ala. 237, 346-350 (1875).

[1] Appendix A, *infra*, pp. 105-109.

and other real and personal property and interests and rights in property owned by the Company or to which it may be entitled, formerly the property of or belonging to Western Pacific Railway Company, a corporation of the State of California, or its receivers:"

This language is followed by specific descriptions contained in six subdivisions.

Subdivision III reads as follows:

"All terminals and *all lands and interests in lands, easements therein and improvements thereon*, including, among other things, yards, station and depot grounds, sheds, station houses, freight houses, warehouses, elevators, stockyards, carhouses, engine houses, oil tanks, water tanks, water supply, shops, hotels, boarding houses, hospitals, docks, wharves, piers, slips, telephone and telegraph lines and other structures and erections and the appurtenances of all and every of the foregoing, *whether or not for use in connection with said or any lines of railroad.*"

Subdivision VII reads as follows:

"All and singular the property, interests and rights, (except cash, accounts and bills receivable, traffic and other operating balances and other cash items) not comprised in the descriptions contained in the foregoing subdivisions of this clause *First* of these granting clauses, which belong to the Company or to which it may be entitled in any manner and which heretofore were owned by Western Pacific Railway Company or to which said company was or its receivers were entitled."

Granting Clause Second[1] covers:

"All other lines of railroad, extensions, branches, terminals, lands, structures, equipment, shares of stock, bonds, notes and other securities, claims, franchises, privileges and immunities and other property and estates, interests and rights (whether legal or

[1] Appendix A, *infra*, p. 109.

> equitable) now owned by or belonging to the Company, notwithstanding the same or any thereof may not be particularly set forth in these granting clauses."

It is difficult to see how the draftsman of the First Mortgage could express more clearly an intent that all property (with certain specified exceptions not relevant to this discussion) owned by the Debtor at the date of the execution and delivery of the First Mortgage, including property acquired by it from its predecessor, Western Pacific Railway Company, should be subject to the lien of the First Mortgage. The words "whether or not for use in connection with said or any lines of railroad", appearing in subdivision III of Clause First, clearly show that the property mortgaged included "noncarrier" property as well as "carrier" property.

The Provisions of the 1915 Plan of Reorganization Are Not Relevant.

The Refunding Mortgage Trustee contends that "noncarrier" real estate owned by the Debtor at the date of the execution and delivery of the First Mortgage is not subject to the lien, because of the provision appearing in Article VII of the plan of reorganization of the Debtor's predecessor, Western Pacific Railway Company, dated December 15, 1915, which describes the new First Mortgage Bonds to be issued by the Debtor pursuant to the plan in the following language (R. 1141):

> "To be secured by first mortgage upon all of the existing railway properties of the Old Company and all property hereafter acquired by the Operating Company integrally connected therewith and all property acquired by means of the use of proceeds of the New Bonds or against which New Bonds shall be issued."

The Refunding Mortgage Trustee contends that the plan "constituted a contract between the stockholders of the Debtor (who were bondholders of the predecessor company) and the new First Mortgage bondholders" and that

to interpret the First Mortgage as covering the "noncarrier" real estate in question "would violate the terms under which the old bondholders agreed to take stock in the new company (the Debtor herein) in exchange for their claims."[1]

We question whether the words "existing railway properties" were used in the plan in a narrow sense as excluding from their meaning physical properties used or acquired for use in the business of the railroad but not used in the actual transportation of passengers and commodities. The provisions of the plan indicate rather that the draftsman used these words to describe the properties of the predecessor company which were to be transferred to the new operating company (the Debtor), as distinguished from the claims against The Denver and Rio Grande Railroad Company which were to be transferred to the new holding company (R. 1135-1136).

The language of Granting Clause First of the First Mortgage,[2] amounts to an interpretation of these words in the plan as having that meaning.[3]

But, even if the words "existing railway properties" be held to exclude from their meaning "noncarrier" real estate, the provisions of the plan are not relevant to the question of the scope of the granting clauses of the First Mortgage. The language used in the above quoted provisions of the granting clauses is clear and free from ambiguity. It plainly includes all "noncarrier" real estate owned by the Debtor at the date of the execution and de-

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[1] Brief of Refunding Mortgage Trustee, p. 53.

Although the distinction seems immaterial, we wish to point out for the sake of accuracy that the bondholders of the predecessor company did not become direct stockholders of the Debtor. Under the plan, all of the stock of the Debtor was placed in the new holding company (R. 1135-1136), and the bondholders of the predecessor company were given stock of the holding company (R. 1143-1144).

[2] Appendix A, *infra*, pp. 105-109.

[3] The agreement of reorganization (R. 1165-1210) provided (R. 1178):

> "The Reorganization Committee may construe the Plan and Agreement and its construction thereof or action thereunder in good faith shall be final and conclusive."

livery of the First Mortgage, including "noncarrier" real estate acquired by the Debtor from its predecessor, Western Pacific Railway Company.

The provisions of the plan are inadmissible to contradict the clear and unambiguous provisions of the granting clauses of the First Mortgage.

CONCLUSION.

We respectfully submit:

1. That this Court, in view of the public interest in bringing about a speedy termination of the reorganization proceedings, should decide the issues involved in the "lien controversy".

2. That this Court should decide that the issues involved in the "lien controversy" were correctly determined by the Commission and by the District Court.

3. That, for the reasons set forth in this brief and in the brief of the First Mortgage Trustees filed in No. 8, this Court should reverse the decision of the Circuit Court of Appeals and affirm the order of the District Court approving the Commission Plan.

Dated, New York, N. Y., October 3, 1942.

Respectfully submitted,

ORVILLE W. WOOD,
Attorney for Respondents Crocker First National Bank of San Francisco and Samuel Armstrong, as Trustees under The Western Pacific Railroad Company First Mortgage dated June 26, 1916.

ARTHUR A. GAMMELL,
Of Counsel.

Appendix A.

The Granting Clauses of the First Mortgage.

"NOW, THEREFORE, THIS INDENTURE WITNESSETH, that, in order to secure the payment of all of said bonds (which are hereinafter called 'First Mortgage Bonds') at any time issued and outstanding under this indenture according to their tenor, purport and effect, as well the interest as the principal thereof, and to secure the performance and observance of all of the covenants and conditions therein and herein contained and to declare the terms and conditions upon which the First Mortgage Bonds are to be executed, authenticated, delivered and received, the Company, in consideration of the premises and of the acceptance or purchase of said bonds by the holders thereof and of the sum of One hundred Dollars, lawful money of the United States of America, to it duly paid by the Trustees at or before the ensealing and delivery of these presents, the receipt whereof is hereby acknowledged, hath granted, bargained, sold, aliened, remised, released, conveyed, confirmed, mortgaged, pledged, assigned, transferred and set over, and by these presents doth grant, bargain, sell, alien, remise, release, convey, confirm, assign, mortgage, pledge, transfer and set over unto the Trustees, their successors in the trust and their assigns forever, all of the following described railways, franchises and other properties (which collectively are hereinafter called the 'trust estate'), to wit:

"*First.*—All and singular the following described lines of railroad, terminals, lands, equipment, shares of stock and other real and personal property and interests and rights in property owned by the Company or to which it may be entitled, formerly the property of or belonging to Western Pacific Railway Company, a corporation of the State of California, or its receivers:

"I.—A main line of railroad commencing in the City and County of San Francisco, running thence in and through said City and County to certain slips, piers and landing places upon San Francisco Bay in said City and County; thence by ferry and barge to the City of

Oakland, in the County of Alameda; thence in and through said City of Oakland; thence in a southeasterly, easterly, northeasterly and northerly direction through the Counties of Alameda and San Joaquin, passing in and through the City of Stockton in said County of San Joaquin; thence in a general northerly direction through the County of Sacramento, passing in and through the City of Sacramento in said county; thence in a general northerly direction through the Counties of Sutter and Yuba, passing in and through the City of Marysville in said County of Yuba; thence in a general northerly direction through the County of Butte, passing through the City of Oroville in said County; thence in a general northeasterly, easterly and southeasterly direction through the County of Plumas; thence in a general northerly and easterly direction through the County of Lassen to a point on the boundary line between the States of California and Nevada; thence in a general easterly and northeasterly direction through the Counties of Washoe, Humboldt, Lander, Eureka and Elko, in the State of Nevada, to a point on the boundary line between the States of Nevada and Utah; thence in a general easterly direction through the Counties of Tooele and Salt Lake, in the State of Utah, to and into Salt Lake City, in said State of Utah—said line of railroad being about 927.3 miles in length.

"II.—A branch line of railroad, having its initial point and connection with said main line at or near Carbona in San Joaquin County, California, and extending thence in a southwesterly and westerly direction to a point near Tesla, Alameda County, California—being about 13 miles in length.

"III.—All terminals and all lands and interests in lands, easements therein and improvements thereon, including, among other things, yards, station and depot grounds, sheds, station houses, freight houses, warehouses, elevators, stock-yards, carhouses, engine houses, oil tanks, water tanks, water supply, shops, hotels,

boarding houses, hospitals, docks, wharves, piers, slips, telephone and telegraph lines and other structures and erections and the appurtenances of all and every of the foregoing, whether or not for use in connection with said or any lines of railroad.

"IV.—All locomotives, motor cars, express cars, dining cars, freight cars, passenger cars; combination cars, work cars and other rolling stock; all ferries, tugs, barges, transfers, lighters, harbor craft and other floating equipment; all machinery, tools and appliances, all electrical generating and transmission and other electrical apparatus and all other equipment, apparatus, appliances and facilities.

"V.—The following shares of stock in other corporations, which are hereby assigned to and simultaneously with the execution hereof are deposited with the Trustees:

995 shares of the par value of $100 each of the capital stock of The Salt Lake City Union Depot and Railroad Company, a Utah corporation, all of the other shares of stock wherein (except 9 shares held by directors)—to wit, 996 shares—are owned or controlled by The Denver and Rio Grande Railroad Company, a consolidated corporation existing under the laws of Colorado and Utah.

4000 shares of the par value of $100 each of the capital stock of Standard Realty and Development Company, a California corporation, being all of the capital stock thereof except 5 shares held by directors.

"VI.—The estates, interests and rights of the Company under any and all leases, leaseholds, rights under leases or contracts, trackage agreements, traffic agreements and operating agreements, and particularly the interests and rights of the Company heretofore possessed by Western Pacific Railway Company (but not including any of the claims or rights against, or with

respect to the property of, The Denver and Rio Grande Railroad Company or any predecessor or successor corporation of, or which originally arose in favor of, holders of the First Mortgage Five Per Cent. Thirty-year Gold Bonds of said Western Pacific Railway Company or of coupons belonging thereto nor any of the proceeds or avails of any such claims or rights whether or not such proceeds or avails shall have been collected or obtained otherwise, in whole or in part, by the use of First Mortgage Bonds or the proceeds thereof unless the same or any part thereof shall hereafter be subjected to the lien hereof by an instrument executed expressly for such purpose) under (1) an agreement, bearing date June 23, 1905, between The Denver and Rio Grande Railroad Company, The Rio Grande Western Railway Company, Western Pacific Railway Company and Bowling Green Trust Company (The Equitable Trust Company of New York being successor thereto), as trustee under the First Mortgage of Western Pacific Railway Company, and (2) an agreement bearing date said last-mentioned day between Missouri Pacific Railway Company and The Denver and Rio Grande Railroad Company; provided, however, that any now existing interest or right of the Company under any lease, agreement or other instrument or contract, which by the terms of a decree of foreclosure and sale entered in a cause pending in the United States District Court for the Northern District of California, wherein The Equitable Trust Company of New York was plaintiff and Western Pacific Railway Company and others were defendants, the Company is entitled to renounce or disaffirm and which pursuant to the provisions of said decree it shall so renounce or disaffirm, shall not be deemed to have been assigned, mortgaged, pledged or otherwise encumbered by this indenture.

"VII.—All and singular the property, interests and rights, (except cash, accounts and bills receivable, traffic and other operating balances and other cash items) not comprised in the descriptions contained in the fore-

going subdivisions of this clause *First* of these granting clauses, which belong to the Company or to which it may be entitled in any manner and which heretofore were owned by Western Pacific Railway Company or to which said company was or its receivers were entitled.

"The lines of railroad, terminals, lands, structures, equipment, shares of stock and other property, interests and rights hereinabove in this clause *First* of these granting clauses described, were formerly the properties, interests and rights of Western Pacific Railway Company or its receivers and were conveyed and assigned to the Company by deed dated July 1, 1916, wherein Francis Krull as Special Master appointed in and by said above mentioned decree of foreclosure and sale is named as party of the first part, said Western Pacific Railway Company as party of the second part, F. G. Drum and Warren Olney, Junior, as receivers of said Western Pacific Railway Company, as parties of the third part, The Equitable Trust Company of New York, as trustee under the First Mortgage of said Western Pacific Railway Company executed to the Bowling Green Trust Company, trustee, as of date September 1, 1903, as party of the fourth part, Central Trust Company of New York, as trustee under the Second Mortgage of Western Pacific Railway Company executed to said Central Trust Company of New York, trustee, and dated July 1, 1908, as party of the fifth part, Franklin V. Spooner, Robert R. Pardow and John C. Rued, as parties of the sixth part, and the Company as party of the seventh part; which deed was executed and delivered to the Company before the execution of this indenture.

"*Second.*—All other lines of railroad, extensions, branches, terminals, lands, structures, equipment, shares of stock, bonds, notes and other securities, claims, franchises, privileges and immunities and other property and estates, interests and rights (whether legal or equitable) now owned by or belonging to the Company, notwithstanding the same or any thereof may not be particularly set forth in these granting clauses.

"*Third.*—Any and all property and facilities of any and every kind and description, including among other things lines of railroad, extensions and branches, telegraph and telephone lines, lines and instrumentalities of water transportation, terminal facilities, equipment, lands, buildings, machinery and tools, stocks, bonds, notes and other obligations and securities and any and all right, title and interest in any of such properties or facilities which may from time to time hereafter be acquired or constructed by or belong to the Company or any successor or purchasing corporation if

(*a*) acquired or constructed by the use of First Mortgage Bonds or proceeds thereof or cash deposited hereunder (except bonds delivered or cash paid out under any of the provisions of this indenture in reimbursement of previous expenditures certified as hereinafter provided) or on account of the purchase, acquisition or construction thereof or work thereon First Mortgage Bonds shall hereafter be authenticated and delivered or the proceeds of First Mortgage Bonds or other cash deposited hereunder shall hereafter be paid out under any of the provisions of this indenture; or

(*b*) consisting of or, if securities, representing property or facilities constituting an integral part or parts of lines of railroad, extensions, branches, or other property subject to the lien of this indenture or some other integral portion whereof is or integral portions whereof are subject to the lien hereof or represented by securities subject to the lien hereof; or

(*c*) consisting of or, if securities, representing property or facilities used or acquired for use in or for the maintenance or operation of or appertaining to any of the lines of railroad, extensions, branches or other property subject, or represented by securities subject, to the lien of this indenture; or

(*d*) consisting of shares of stock in or other securities of said The Salt Lake City Union Depot and Railroad Company or said Standard Realty and Development Company or any subsidiary company or any right,

title or interest which the Company or any successor or purchasing corporation may hereafter acquire in or to any of the property of either of said companies or in or to any line of railroad or other property of any corporation which shall then be or immediately prior thereto shall have been a subsidiary company, as the term 'subsidiary company' is defined in Section 2 of Article Second hereof.

"*Fourth.*—Any and all lines of railroad and other property of whatsoever kind or description, which may include, among other things, stocks, bonds, notes and other obligations and securities and also claims, demands and choses in action of whatsoever kind, from time to time hereafter by delivery or by writing of any kind, for any of the purposes hereof, conveyed, assigned, transferred, mortgaged or pledged by the Company or by any successor or purchasing corporation or by any person or corporation on behalf of any of them or with the written consent of any of them to the Trustees, who are hereby authorized to receive any such property at any and all times as and for additional security hereunder and also when and as hereinafter provided as substituted security hereunder and, except as hereinafter otherwise expressly provided and except with respect to anything which by or under any other of the provisions of this indenture is mortgaged or pledged or agreed to be mortgaged or pledged or to be subjected to the lien hereof as security hereunder, any such conveyance, assignment, transfer, mortgage or pledge may be made subject to any conditions, reservations, limitations and provisions which shall be set forth in an instrument in writing then to be executed by the Company or the person or corporation making such conveyance, assignment, transfer, mortgage or pledge respecting the use, management and disposition of the property constituting such additional security and the proceeds thereof.

"*Fifth.*—All rights of way and other easements; all tunnels, roadbeds, main tracks, double tracks and other additional tracks, spurs, side tracks, turn-outs, switches, turn-

tables; all superstructures, bridges, viaducts, stringers, ties, rails, frogs and bolts; all fences, telegraph and telephone lines, poles, wires, block signals and instruments; all terminal facilities; all wharves, docks, slips, piers, floats, loading and unloading apparatus and landings; all steamships, tugs, ferries, barges, lighters and other floating equipment; all passenger stations, freight houses, warehouses, elevators, power houses, coal houses, oil tanks, car-houses, engine houses, machine shops and other shops and structures; all water stations, water tanks and water supplies; all locomotives, tenders, motor cars, express cars, postal cars, dining cars, baggage cars, passenger cars, combination cars, work cars, freight cars and other rolling stock and equipment; all machinery, apparatus, tools, implements, appliances, furniture, material and supplies; all land used or designed for way-grounds, terminals, yards, stations, depots, warehouses or other structures or facilities; all other property of every description and all rights and interests in or with respect to the use of property; provided that the foregoing or any thereof, whether now owned by the Company or at any time hereafter acquired by it or any grantee, successor or purchasing corporation, shall be appurtenant to or used or held for use as, or as a part or as parts of, or to facilitate or safeguard the maintenance or operation of, any lines of railroad, extensions, branches, telegraph or telephone lines, lines of water transportation, terminal facilities or other properties now or at any time hereafter subject to the lien of this indenture—whether the same exclusively appertain to or be used as parts of or in or for the maintenance or operation of lines of railway or other properties subject to the lien hereof or appertain to or be so used as parts of or in or for the maintenance or operation of such lines of railroad or other properties in common with lines of railroad or property not subject to the lien hereof; also all corporate and other rights, franchises, privileges and immunities now appertaining or hereafter to appertain to or used or held for use in or for the maintenance or operation of any such lines of railroad or other property now or at any time hereafter subject to the lien of this indenture, whether

the Company now owns or it or any successor or purchasing corporation hereafter shall acquire any such rights, franchises, privileges or immunities; also any and all replacements, renewals, improvements and betterments of and additions to any such lines of railroad or any property or rights of whatsoever description now or at any time hereafter subject to the lien of this indenture, whensoever and by whomsoever such replacements, renewals, improvements, betterments or additions may be made.

"*Sixth.*—All and singular the estates, rights, titles, interests, possession, claims and demands, whatsoever, as well at law as in equity, of the Company and of any successor or purchasing corporation of, in or to any of the lines of railroad, extensions, branches, telegraph and telephone lines, lines of water transportation, terminal facilities, equipment, lands and other properties, hereditaments, appurtenances, rights, franchises, privileges and immunities hereby conveyed, assigned, mortgaged or pledged or intended to be conveyed, assigned, mortgaged or pledged or now or at any time hereafter subject to the lien of this indenture and every part and parcel thereof, and all and singular the rents, issues, tolls, profits and other income of all and every part of the property of whatsoever kind or description hereby conveyed, assigned, mortgaged or pledged or intended to be conveyed, assigned, mortgaged or pledged or now or at any time hereafter subject to the lien of this indenture.

"But nothing express or implied in this indenture shall be construed to limit the right or power of the Company or any successor or purchasing corporation, which right and power is hereby expressly reserved, by the use of its credit or free funds or by the use of First Mortgage Bonds delivered to the Company or any successor or purchasing corporation as in this indenture provided to reimburse the Company or any such successor or purchasing corporation for expenditures theretofore actually made out of its free funds, to construct or acquire free from the lien hereof lines of railroad, extensions or branches or interests therein, equipment, stocks, bonds or other securities or other prop-

erty, rights, franchises, immunities or privileges provided the same shall not be lines of railroad, extensions, or branches or interests therein, equipment, stocks, bonds or other securities, or other property, rights, franchises, immunities or privileges (*a*) on account of the purchase, acquisition or construction whereof or work whereon First Mortgage Bonds shall be authenticated and delivered or their proceeds or other cash deposited hereunder shall be paid out as herein provided; or (*b*) consisting of, or if securities representing, property or facilities constituting an integral part or parts of lines of railroad, extensions, branches or other property subject to the lien of this indenture or some other integral portion whereof is or integral portions whereof are subject to the lien hereof or represented by securities subject to the lien hereof; or (*c*) consisting of or, if securities, representing property or facilities used or acquired for use in or for the maintenance or operation of appertaining to any of the lines of railroad, extensions, branches or other property subject, or represented by securities subject, to the lien of this indenture; or (*d*) consisting of shares of stock in or other securities of said The Salt Lake City Union Depot and Railroad Company or said Standard Realty and Development Company or any subsidiary company or of any right, title or interest which the Company or any successor or purchasing corporation may acquire in or to any of the property of either of the companies above named or in or to any line of railroad or other property of any corporation which shall then be or immediately prior thereto shall have been a subsidiary company as the term subsidiary company is defined in Section 2 of Article Second hereof; and the Company may, unless First Mortgage Bonds shall have been authenticated and delivered or their proceeds or other cash deposited hereunder paid out against the same, purchase and acquire equipment, free from the lien hereof, by lease, conditional sale agreement or under any form of equipment trust, or purchase such equipment and issue obligations therefor secured by mortgage or pledge of such equipment superior to the lien of this indenture.

"To Have and to Hold the premises, railways, properties, securities, rights, franchises, estates and appurtenances hereby conveyed or assigned or intended to be conveyed or assigned unto the Trustees, their successors in the trust and assigns forever.

"Subject, However, as to all equipment now owned to the equipment trust or conditional sale agreements secured thereon, and as to equipment hereafter acquired, to the equipment trust or conditional sale agreements to which the same shall be subject as permitted hereby, and as to any property hereafter acquired by the Company or by any successor or purchasing corporation and becoming subject to the lien of this indenture, to any liens thereon existing at the time of such acquisition and not expressly prohibited by the terms of this indenture.

"But in Trust Nevertheless for the equal and proportionate benefit and security of all present and future holders of the First Mortgage Bonds and coupons and for the enforcement of the payment of said bonds and coupons when payable and the performance and observance of and compliance with the covenants and conditions of this indenture, without preference, priority or distinction as to lien or otherwise of one bond over any other bond by reason of priority in the issue, sale or negotiation thereof, or the purpose of its issue, so that each and every bond hereby secured shall have the same right, lien and privilege under and by virtue of this indenture and, subject to the terms hereof, be equally and proportionately secured hereby, as if all of the First Mortgage Bonds had been made, executed, authenticated, delivered and negotiated simultaneously with the execution and delivery of this indenture, it being intended that the lien and security of this indenture shall take effect from the date of the execution and delivery hereof without regard to the time of the actual issue, sale or negotiation of said bonds as though upon said date all of said bonds were actually authenticated, issued, sold and delivered and were in the hands of holders in due course."

Appendix B.

OPINION OF COURT ON EXCEPTIONS TO MASTER'S REPORT ON EQUIPMENT LIEN CONTROVERSY.

(FILED OCTOBER 31, 1939.)

IN THE

DISTRICT COURT OF THE UNITED STATES

FOR THE NORTHERN DISTRICT OF ILLINOIS,

EASTERN DIVISION.

IN THE MATTER of THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY, *Debtor.*	No. 53209.

ON EXCEPTIONS TO THE MASTER'S REPORT ON EQUIPMENT LIEN CONTROVERSY.

WILKERSON, *District Judge:*

The reorganization petition herein was filed on June 7, 1933. The Supreme Court of the United States, affirming the injunctional orders of this court against suits by creditors, on April 1, 1935, said:

> "Not only are those who institute the proceeding and those who carry it forward bound to exercise the highest degree of diligence, but it is the duty of the court and of the Interstate Commerce Commission to see that they do. Proceedings of this character, involving public and private interests of such magnitude, should, so far as practicable, be given the right of way both by the court and by the commission, to the end that they may be speedily determined." (*Con-*

tinental Bank v. *Rock Island Railway*, 294 U. S. 648, 685.)

On August 6, 1935, the court entered an order requiring the debtor to show cause why it should not be required to file a reorganization plan by November 1, 1935. The debtor, on September 16, 1935, invoked the Act of Congress of August 27, 1935, amending paragraph 77(d) of the Bankruptcy Act and requested additional time for filing the plan. The court discharged the rule to show cause and granted extensions for filing the plan from time to time until July 15, 1936. On that date a plan was filed by the debtor with the Interstate Commerce Commission. The hearings on the plan have proceeded before the commission and on September 22, 1939, the examiner appointed by the commission filed a report to the commission which contains recommendations for a plan. The hearing on the report is to be had before the commission on December 7, 1939.

On May 24, 1937, while the hearing on the plan was proceeding before the commission, the mortgage trustees and protective committees representing the general gold bond mortgage and the first and refunding mortgage of the debtor filed their petition for an order "declaring the rights and other legal relations of the parties" with reference to certain equipment mentioned in the petition. Answers were filed by the railway company, by protective committees representing Choctaw, Oklahoma and Gulf mortgage bonds, Rock Island, Arkansas and Louisiana mortgage bonds, and St. Paul and Kansas City Short Line mortgage bonds, by trustees under most of the mortgages, and by the Reconstruction Finance Corporation.

The propriety of a hearing by the court before the commission had concluded its hearings on the plan and had reported to the court was not questioned by any of the parties. The petitions did not refer to any provisions of the act relating to the reorganization of railroads which authorized or required the court to hold such a hearing

before the commission had passed upon the questions relating to the reorganization plan.

On July 27, 1937, an order was entered referring the petition to a special master for hearing and report upon facts and law. The report of the special master was filed on April 4, 1939. Exceptions to the report were duly filed and were heard by the court on July 24, 1939.

In the order of reference the equipment involved is called "disputed equipment", which the order defines as equipment owned by the principal debtor at the time of the filing of the original petition of the principal debtor herein and not since retired, and which has been used indiscriminately over the lines operated by the trustees of the principal debtor, except:

> (a) equipment specifically pledged or allocated by the principal debtor on its present records under any of the principal debtor's own mortgages;
>
> (b) equipment acquired by the principal debtor from the Burlington, Cedar Rapids and Northern Railway Company; and
>
> (c) equipment acquired through the use of any of the mortgage bonds of the principal debtor or of any of its subsidiary companies or the proceeds of any such bonds;

and shall not include any equipment allocated by the principal debtor on its present records to any of its subsidiary companies, or any equipment used exclusively on any mortgaged or leased line, but shall include the right, title and interest of the principal debtor and/or trustees of the principal debtor in and to the equipment subject to the principal debtor's equipment trust agreements.

The questions at issue relate to the proper construction of mortgage provisions and provisions in leases in so far as they may relate to a lien upon or property interest in any portion of the "disputed equipment", and the proper method or measure of determining the extent of any lien upon or property interest in the "disputed equipment" which the mortgage trustee or the lessor under

a lease, as the case may be, may have under any such instruments.

The lease provisions that are pertinent relate to replacement of equipment worn out or no longer fit for service, and equipment added to the leased property and referred to in the lease as additions and betterments. The mortgage provisions that are pertinent relate to replacement of equipment worn out or no longer fit for service and which was subject to the mortgage lien, and to so-called "after acquired" equipment.

The questions involved are difficult and complicated and the answers to them in some instances are not free from doubt. The master has made a report in which he has analyzed the provisions in question and has stated fully and ably his reasons for the construction which he places upon them. The court is asked to rule upon the exceptions to the master's report and to enter an order declaring the rights of the respective parties with reference to the equipment in question.

Before considering the questions presented by the pleadings and the report we should look into the nature of this proceeding and inquire into the scope of the order which the court properly may make concerning matters which are involved in the reorganization plan while the hearings on the plan are being held by the commission and before the commission has made its report on the plan to the court.

The duty and authority of the commission and the court in reorganization proceedings must be found in the statute. The proceeding is not a bankruptcy although an amendment to the Bankruptcy Act creates and regulates the remedy. (*Louden* v. *Northwestern National Bank*, 298 U. S. 160, 163, 164.)

The court is charged with the responsibility for the operation of the business and the conservation of the assets while the reorganization proceeding is pending. The court is charged with the duty of requiring the debtor and trustees to file schedules and submit information necessary to disclose the conduct of the debtor's affairs and the fair-

ness of any proposed plan, and of directing the preparation of lists of bondholders, stockholders and creditors. The court is required to fix a time within which claims may be filed, and for the purposes of the plan and its acceptance to make a classification of creditors and stockholders according to the nature of their respective claims and interests. Section 77(c)(7) provides that while the trustee under any mortgage, deed of trust or indenture may file a claim in behalf of all securityholders thereunder, such trustee may not be the representative of such holders for the purpose of accepting or rejecting any plan of reorganization.

The initial proceedings with reference to the reorganization plan are placed exclusively within the control of the commission. At the hearings before the commission all interested parties are entitled to be heard. Section 77(d) expressly provides that "no plan shall be approved or confirmed by the judge in any proceeding under this section unless the plan shall first have been approved by the commission and certified to the court".

When the plan is certified all parties in interest are entitled to be heard by the court upon the question of its fairness, and, as has been pointed out above, trustees may not represent the owners of securities issued under their respective trust deeds at that hearing.

It is not necessary to decide whether or not a determination by the court of the conflicting claims to the equipment in question could be made binding upon those who have joined in submitting their claims to the court at this time. There are so many parties in interest entitled to be heard on the fairness of the plan who have not joined in this application and who would not be bound by the court's decision that whatever the court might now decree would have to be re-examined in the light of the plan when certified, and the objections thereto. The court may not pass upon a plan piecemeal, nor has it the authority in advance of the certification of a plan by the commission to bind all interested parties by finally adjudicating controversies between some of the interested parties which

may be presented when the plan is before the court for approval or disapproval.

The reorganization proceedings may be dismissed, in which case the title to the estate reverts to the debtor with the rights of all parties unimpaired except as they may have been changed by the judgment of the court upon such matters as the court is expressly authorized by the statute to adjudicate during the pendency of the proceeding.

However, there has been a long hearing before the master in accordance with the directions of the order of reference, and the objections to the report of the master have been heard by the court. It is proper that the court should give its conclusions upon the controversies stated in the order of reference and the master's report. Those findings are necessarily interlocutory in their character. They are in no way binding upon the commission in framing a plan to be certified to the court. They are not binding upon any of the parties at the hearing on the plan. They cannot affect the rights of any of the parties if this proceeding is dismissed and creditors are obliged to seek redress in other forums. The most that can be said for them is that this preliminary and tentative ruling may furnish a basis for discussion at the hearing on the plan and may tend to expedite the court proceedings.

If decisions on the matters in controversy are necessary to a ruling on the fairness of the plan when it is before the court, final ruling will be made at that time in connection with the order concerning the plan. It is possible that a plan may be presented as to the fairness of which some or all of the matters covered by the master's report may not be relevant.

With the foregoing limitations as to their effect, the court states its findings as follows:

The main controversies here grow out of conflicting constructions placed upon certain provisions of the general and first and refunding mortgages relating to the lien of the mortgages upon after acquired equipment.

When the general mortgage was executed, January 1, 1898, the lines of railway then in operation consisted

of 3500 miles. When the petition for reorganization was filed June 7, 1933, the mileage had increased to more than 8000 miles. It is clear from the language of the mortgage that the parties to it contemplated new branches, extensions and the addition of leased lines, and that is what actually occurred. The lines of the railway company then and since have been operated as a single system of railway lines, and in practice at least the equipment later acquired was put to indiscriminate use on all parts of the system lines.

The mortgages in question, so far as they deal with after acquired equipment, are not drafted with that degree of certainty and precision which one would expect to find in documents of that character. The intention of the parties is not embodied in any clear-cut, definite provision; but must be ascertained by patching together and interpreting several sections, each of which makes some reference to equipment acquired after the execution of the mortgages. The security holders under the mortgages contend for an interpretation which makes a large part of the after acquired equipment subject to the liens of their mortgages. Interests junior to the mortgages contend for an interpretation which limits materially the rights of the mortgages in after acquired equipment.

The problem presented to the court is to determine the intention of the parties by analyzing all of the mortgage and lease provisions that may be relevant, in the light of the purpose of the parties and the means adopted to accomplish such purpose.

The order of reference excludes consideration with respect to liens upon or property interest in specific units of equipment, or with respect to what specific units of equipments fall within the category of "disputed equipment". In view of the pending reorganization proceedings, and subject to the limitations placed upon the findings herein, a determination of the rights of the parties herein may be stated in terms of the value of such rights.

General Gold Bond Mortgage:

The introductory paragraph to the several granting clauses conveys to the trustee in trust the railways "now owned or leased", together with "other property now held * * * or hereafter acquired * * *, and being a part of or appurtenant to or provided for use upon any such railway."

This is followed by two granting clauses which describe the main lines and branches of said railway.

Granting clause THIRD consists of three parts: (1) lands such as road beds, station grounds and yards, "now held * * * or hereafter acquired * * *, and appertaining to or provided for use in connection with" said railway; (2) buildings and structures, such as bridges, depots, warehouses, engine-houses, shops and other structures, and tracks, "now held * * * or hereafter acquired * * *, and appertaining to any of said railways"; and (3) personal estate, such as tools, machinery, supplies, locomotives, cars and other rolling stock, and equipment, "now held * * * or hereafter acquired * * *, and appertaining to or provided for use upon" said railway.

Article Six, section 2, provides:

> "While in possession of the mortgaged premises the Railway Company shall * * * have full power, in its discretion, from time to time, to dispose, free from the lien of this indenture, of any portion of the * * * rolling stock, or equipment embraced within this indenture, which may have become unfit for such use, replacing same by, or substituting for the same, new * * * rolling stock, or equipment, which shall become subject to the first lien of this indenture."

Obviously, equipment later acquired and used for the purpose stated in Article Six, section 2, would be equipment "hereafter acquired * * * and appertaining to or provided for use upon" said railway, as set forth in Granting Clause THIRD.

The indenture, dated January 1, 1898, was to continue in effect until January 1, 1988, or for a period of 90 years.

The equipment in existence when the indenture took effect would become unfit for use or obsolete long before the maturity date. There is no doubt the parties understood when the indenture was executed that such equipment and rolling stock would have to be replaced several times within a period of 90 years if the railway were to continue as a going concern.

To dispose of something is to divest oneself of possession. This may be done by sale, gift or destruction of the article if no longer useful. In the case of railway equipment, the usual method is to dismantle the equipment and sell or reuse the salvage. The discretion lodged in the railway company by the provision quoted was the authority to determine from time to time when any equipment had become unfit for use.

The paragraph quoted above did two things: (1) It empowered the railway company to sell or dismantle any rolling stock or equipment that no longer was fit for service, free from the lien of the indenture, and (2) it placed upon the railway company the duty to acquire other rolling stock or equipment to take its place, which then became subject to the first lien of the indenture. By so doing it was intended that the mortgage security with respect to rolling stock and equipment should remain unimpaired throughout the term of the indenture. Rolling stock and equipment, so acquired by the railway company to replace original equipment or to replace rolling stock or equipment which itself had been acquired for replacement purposes, would come within the mortgage description (Granting Clause Third) of rolling stock or equipment "hereafter acquired * * *; and appertaining to or provided for use upon" said railway.

Assuming that the railway company discharges its duty to maintain unimpaired the mortgage security with respect to rolling stock and equipment by replacing each unit no longer fit for service, and that it acquires with its own funds or by other means independently of the mortgage additional rolling stock or equipment which may be used upon the railway subject to the mortgage, is such addi-

tional equipment subject to the mortgage lien? This will depend upon the intention of the parties as expressed by the language used by them in the indenture.

Granting Clause THIRD, as noted above, conveys to the mortgage trustee all locomotives, cars and other rolling stock and equipment "now held * * * or hereafter acquired * * *, and appertaining to or provided for use upon" said railway. On its face, this language, if not qualified by other language in the indenture, would seem to be broad enough to include additional rolling stock or equipment of the kind defined in the preceding paragraph. But, at the end of Granting Clause FOURTH, a proviso will be noted that may materially qualify or circumscribe the broader language in Granting Clause THIRD. Before discussing this proviso, that part of Granting Clause FOURTH that precedes the proviso may be noted, and the rule remembered that the essential function of a proviso is to limit or qualify something previously expressed. Granting Clause FOURTH relates to "all other property" or property not subject to the mortgage lien, which the mortgagor may, if it should so elect, convey to the mortgage trustee "as and for additional security". Thus it is recognized and conceded that the mortgagor may acquire and hold other property not conveyed to the mortgage trustee by the granting clauses of the indenture. The nature of such other property, that later may be acquired by the mortgagor, is described in the proviso at the end of Granting Clause FOURTH. The proviso reads:

> "And *Provided*, further, that nothing in this indenture contained shall be construed to limit the right or power of the Railway Company, hereby expressly reserved, to own and hold, or in any manner, except by the use of bonds secured by this indenture, to construct or to acquire, by purchase or by lease, other lines of railway, branches or extensions, *or* equipment or interest therein, *or* new terminals, and to hold and to dispose of, any line or property so acquired, and to retain the proceeds thereof free from the lien of this indenture."

It may be noted here that the words "or property so acquired" obviously apply to and include "equipment", appearing in a preceding line of the proviso. And it may be noted that equipment later acquired by the use of bonds secured by the mortgage is to be subject to the mortgage lien.

It is said that the words "or equipment or interest therein", although the proviso itself discloses no qualification, must be held to relate only to equipment that does not appertain to or is not provided for use upon the railway lines subject to the mortgage; that the words should be qualified by implication so that they will refer only to equipment acquired by the railway company as a part of or for use upon "other lines of railway, branches or extensions" not subject to the mortgage. Under said proviso the railway company is permitted with its own means to acquire other lines of railway, and to hold such lines of railway free from the lien of the indenture. A line of railway without equipment could not be held to be a complete railway; it would be so many acres of land, and so many tons of steel rail. With equipment with which to operate, it would be a completed unit as a railway. Therefore, the words "other lines of railway" would appear to be sufficient in themselves to include equipment, and to negative the assertion that the words "or equipment or interest therein" as used in the proviso must be limited in their meaning to equipment acquired as a part of such other line or lines of railway. Further, if the parties considered it necessary to make specific mention of equipment in connection with purchase of "other lines of railway", it is reasonable to believe that the conjunctive and not disjunctive would have been used. They would have said "other lines of railway *and* equipment". The words are "other lines of railway * * * or equipment". The use of the word "or" in the proviso would mean that the railway company might purchase on its own credit another line of railway together with the equipment thereon, or that it might purchase the equipment without purchasing the right of way. If it purchased only the equipment, then

such equipment would appear to be within the proviso and excluded from the mortgage lien. If equipment purchased from another line of railway without purchase of the right of way would not be subject to the mortgage lien, then equipment purchased elsewhere with free money should not be held to be subject to the lien.

The proviso specifically mentions "or new terminals" as property which the railway company may acquire with its own funds free from the mortgage lien. If the meaning of the proviso, which has been advanced, is to be applied to the case of new terminals, then only "new terminals" on other lines of railway acquired with free money could be constructed free from the mortgage lien. But if the "other line of railway" may be acquired with free money without becoming subject to the mortgage lien, why include in the proviso "new terminals" on such other line? It would seem that such new terminals would be free from the mortgage lien for the same reasons that the new line itself would be free from the lien. It is necessary to look elsewhere for the place to apply the words "or new terminals", and apparently such other place would be the lines of railway that are subject to the indenture.

It is noted that the proviso in all of its parts employs the conjunction "or" and not "and". The word "and" means joining together. The word "or", when attached to an object, implies an object the acceptance of which excludes all other objects. Thus it would appear that under the proviso the railway company is permitted with its own funds to acquire other lines of railway free from the mortgage lien, or that under the proviso the railway company is permitted to acquire with its own funds branches or extensions free from the mortgage lien, or that under the proviso the railway company is permitted with its own funds to acquire equipment or interest therein free from the lien of the mortgage, or that under the proviso the railway company is permitted to acquire with its own funds new terminals free from the lien of the mortgage. Nowhere in the proviso is there any restriction

on or qualification of the permissive right to do any one of the enumerated acts independently of the others.

The railway company is required by the indenture to acquire with its own funds new equipment to replace equipment no longer fit for use. It is stated that the equipment in existence at the date of the indenture, and which became subject to the mortgage lien, constituted 18,831 units. During 90 years most of this equipment would have to be replaced several times. It is likely that under its covenant to replace, the railway company would be obliged to acquire with its own funds 50,000 units. These replacement units would constitute equipment "hereafter acquired * * * and provided for use upon" said railway under Granting Clause THIRD, and as such they would become subject to the lien of the mortgage. Equipment acquired by the railway with its own funds in addition to equipment acquired for replacement should be held to be free from the mortgage lien by virtue of the right reserved to the railway company under the proviso in Granting Clause FOURTH.

Attention is called to Article Two, section 2, of the indenture, which obligates the railway company, when required by the mortgage trustee, to convey to the trustee all real and personal estate acquired by the railway company as appertaining to, or for the use of, the railway subject to the mortgage. Section 2 then provides:

> "But nothing in this indenture expressed or implied is intended or shall be construed, to limit the right or power of the Railway Company, hereby expressly reserved, in any manner, except by the use of bonds secured by this indenture, to construct, or to acquire, and to own and hold, other lines of railway, or branches or extensions, or interest therein, or other property, free from the lien hereof."

The words "other property" mean property that is not subject to the mortgage. If, under the proviso of Granting Clause FOURTH, equipment purchased by the railway company with its own funds in addition to that which

is necessary for replacements is free from the lien of the mortgage, the mortgage trustee is not empowered to demand a conveyance of any such equipment.

If the parties intended that only after-acquired equipment, obtained by the railway company on its own credit for use upon lines of railway not subject to the mortgage, should be excluded from the mortgage lien, there was no reason why that intention could not have been stated in clear and unmistakable terms. The intention should not be left to be determined by conjecture or inference if two provisions or clauses, not harmonious on their face, can be reconciled by allocating to each a separate field of operation that will not be in conflict with the other. That result follows by a determination that the after-acquired property clauses apply to equipment later acquired to replace equipment no longer fit for service, and equipment acquired by the use of general mortgage bonds; and that equipment later acquired by the railway company on its own credit, without further qualification, is not subject to the mortgage lien.

The General Gold Bond Mortgage is entitled to credit against the "disputed equipment" for (1) so much of said equipment as was necessary on June 7, 1933, to replace any of the original equipment; (2) so much of said equipment as was necessary on that date to replace equipment acquired by the use of general mortgage bonds; (3) so much of said equipment as was necessary on that date to replace original equipment that was subject to a subordinate lien under the indenture, but which later became subject to a first lien under the indenture when a prior lien was discharged; and (4) such part as of June 7, 1933, of the equity of the railway company under then existing equipment trusts as might have been necessary on that date to satisfy clause (1), clause (2) and clause (3) in this paragraph.

First and Refunding Mortgage:

This indenture is dated April 1, 1904. Granting Clause FIRST describes (1) the lines of railway then owned

and leasehold interests then held by the railway company, subject to certain existing mortgages therein described; (2) certain rolling stock and equipment consisting of 5,823 units upon which the mortgage is a first lien; and (3) defined classes of appurtenances of the railways previously described, such as telegraph lines, rights of way, depot grounds, switches, bridges, rails, terminal properties, warehouses, engine-houses, water tanks, machine shops, engines, cars and other rolling stock and equipment "appurtenant to any of said lines of railway and branches above described". It is stated that at the date of this mortgage the railway company was in possession of 39,500 units of equipment. Granting Clause SECOND of the indenture places under the mortgage lien "any and all * * * rolling stock and other equipment * * * which, from time to time, in the manner hereinafter provided, shall be purchased, acquired or constructed by the use of any of the bonds secured by this indenture except bonds issued or to be issued under the provisions of sections 2 and 3, or either of them, of Article ONE of this indenture."

Article FOUR, section 8, of the indenture provides that all locomotives, tenders, cars and other equipment upon which the indenture "shall be or become" a first lien shall be marked to distinguish such equipment from other equipment; that the railway company will maintain "such" equipment in good order and condition, reasonable wear and tear excepted; that whenever "such" equipment shall be worn out or destroyed the railway company will cause the same to be replaced by other equipment of at least equal value upon which the indenture shall be a first lien. Article NINE, section 1, contains a further provision which appears to be patterned after Article SIX, section 2, of the General Gold Bond Mortgage. The provision reads:

> "The Railway Company from time to time, while in possession of any of the property subject to this indenture, also shall have full power in its discretion to dispose of any portion of the machinery, equipment and implements, at any time subject to the lien hereof, which may have become unfit for such use, replac-

ing the same by new machinery, equipment or implements, of equal value, which shall become subject to this indenture. In no event shall any purchaser or purchasers of any property sold or disposed of under any provision of this article be required to see to the application of the purchase money."

The indenture imposed a duty on the railway company to replace from time to time the 5,823 units of equipment specified in Granting Clause First, VII, upon which the indenture was a first lien. Also, it imposed a duty on the railway company to replace equipment upon which the lien of the indenture was subordinate to any prior mortgage, such duty beginning as of the date when any such prior mortgage was paid off or otherwise discharged. Granting Clause First, VIII, applied to all equipment appurtenant to the lines of railway subject to the mortgage lien. Thus the indenture became a second lien upon that part of the equipment that was subject to then existing prior liens. Upon removal of any such prior lien the indenture became a first lien on such equipment. And for the reason that equipment acquired by the railway company by the use of mortgage bonds became subject to the indenture as a first lien thereon, if issued under sections 4, 5 and 6 of Article One, a duty was imposed to replace such equipment when no longer fit for service.

Other equipment acquired by the railway company not required for replacement purposes may be designated, for convenience, additional equipment. Does the indenture subject such additional equipment to the mortgage lien?

It is claimed that Granting Clause First, VIII, subjects such additional equipment, later acquired, to the mortgage lien. The grant of the railway property itself is found in Granting Clause First. This clause is separated into three general divisions: *First*, the fixed property comprising railway lines; *Second*, rolling stock specifically enumerated; and *Third*, appurtenances. The third division mentioned is

Granting Clause First, VIII, and bears the heading "Appurtenances". Under that heading what are deemed to be appurtenances are named or defined. The list is too long to be repeated here, but it includes such property as telegraph wires, roadbeds, turnouts, rails, terminals, warehouses, engine houses, shops, tools, furniture, *engines and cars*, tolls, earnings, and estate, right, title, interest, property, possession, claim and demand of the railway company in and to the mortgaged lines. Being included as appurtenances, the terms "estate, title or interest of the Railway Company in and to the mortgaged lines" appear to be used in the sense of legal rights or demands affecting the property conveyed to the mortgage trustee as distinguished from the physical property itself. Then follows the language in dispute, which is added at the end of the paragraph defining "Appurtenances". It reads:

> "* * * with the appurtenances * * * appertaining or hereafter to appertain thereto * * *"

Appertaining to what? The natural construction would be that the word "thereto" necessarily refers to the property described in the preceding part of the paragraph, as set forth above. Under this construction the "appurtenances * * * appertaining or *hereafter* to appertain thereto" would be appurtenances of or to the items of property named or defined in said Granting Clause First, VIII, including appurtenances "hereafter to appertain" to "engines, tenders, cars and other rolling stock." They would not include the engines or cars themselves, later acquired. At any rate, it may not be said that the words "appurtenances * * * appertaining or hereafter to appertain thereto" are so definite and direct in their application as to exclude the meaning that the appurtenances referred to are those connected with the objects described in Granting Clause First, VIII, such as engines, cars and other rolling stock.

Granting Clause Second of the indenture pledges "any and all lines of railway, extensions and branches * * *,

and any and all terminal properties, shops, machinery, tools * * *, rolling stock and other equipment * * *, which from time to time * * * shall be purchased, acquired or constructed by the use of any bonds secured by this indenture except bonds issued under the provisions of sections 2 and 3, or either of them, of ARTICLE ONE". Any of the aforesaid properties acquired by the use of bonds issued under the provisions of sections 4, 5 and 6, or any of them, of Article ONE would be subject to the mortgage lien, but not so if acquired by the use of bonds issued under sections 2 or 3. If the parties intended that the *additional* equipment as defined above was to become subject to the lien of the mortgage, why did they exclude from Granting Clause SECOND "rolling stock and other equipment" acquired by bonds issued under the provisions of sections 2 and 3 of Article ONE? The inference here would be that rolling stock and equipment acquired by the use of bonds issued under sections 2 and 3 would be free from the mortgage lien. It may be urged that equipment, referred to in Granting Clause SECOND, acquired by the use of bonds issued under sections 2 and 3, was to be equipment acquired for use upon new lines or extensions acquired by the railway company on its own credit. But Granting Clause SECOND contains no such restriction as to where equipment acquired by the use of bonds is to be used. On its face the language seems clear enough. It must mean that equipment acquired by the use of bonds issued under sections 2 and 3 is to be free from the mortgage lien whether acquired for use on new lines or extensions or on the lines of railway granted to the mortgage trustee, and that if acquired by the use of bonds issued under sections 4, 5 or 6 it is subject to the mortgage whether acquired for use on new lines or extensions or on the lines of railway granted to the mortgage trustee by Granting Clause FIRST of the indenture.

Granting Clause THIRD conveys to the mortgage trustee any and all additions and betterments "now or hereafter acquired" in connection with any of the lines of railway subject to the mortgage, and "any and all prop-

erty, real or personal, of every kind and description" acquired for use upon such lines of railway. It is claimed that "all property, real or personal," acquired for such use should be construed to include the *additional* equipment. If that is proper, then it would follow that *additional* equipment acquired for such use by the issuance of bonds under sections 2 and 3 of Article One of the indenture would be subject to the mortgage lien. But Granting Clause Second provides that rolling stock and other equipment acquired by the use of bonds issued under sections 2 and 3 shall be free from the lien of the mortgage. This seeming conflict would be resolved if the words "all property, real or personal" were to be applied, so far as equipment is concerned, to equipment acquired for replacement purposes and equipment acquired by the issuance of bonds under sections 4, 5 and 6, or either of them, of Article One. If there be uncertainty in this respect, it may perhaps be avoided by what has been called "the free property clause" immediately following Granting Clause Third of the indenture.

The so-called free property clause provides:

> "But nothing expressed or implied in this indenture is intended, or shall be construed, (a) to limit the right or power of the Railway Company, hereby expressly reserved, by the use of its credit, or by the use of bonds issued or to be issued under the provisions of Sections 2 and 3, or either of them, of Article One of this indenture, or in any manner other than by the use of bonds issued or to be issued under the provisions of Sections 4, 5 and 6, or any of them of Article One of this indenture, or their proceeds, to construct or acquire lines of railway, branches or extensions, or interests therein, or other property, free from the lien hereof; or (b) to subject to the lien of this indenture any hereafter acquired property of the Railway Company * * * other than as *expressly* granted in the Granting Clause of this indenture, which shall be purchased, constructed or acquired in any manner other than by the use of bonds issued or to be issued under the provisions of Sections 4, 5 and 6, or

any of them, of Article ONE, of this indenture, or their proceeds."

Thus the railway company is permitted to acquire, by use of its own credit, or by use of bonds issued or to be issued under sections 2 and 3 of Article ONE, "lines of railway, branches or extensions, or interests therein, *or other property*," free from the mortgage lien. It is asserted that the words "property, real or personal", in Granting Clause THIRD should be construed to include after-acquired equipment. If that meaning be accepted, then no reason is shown why the word "property" in the free property clause should not be construed to include after-acquired equipment. The free property clause provides three modes of acquisition:

(1) acquisition by use of railway company credit,

(2) acquisition by use of bonds issued under sections 2 and 3 of Article ONE, and

(3) acquisition in any other manner than by use of bonds issued under sections 4, 5 and 6 of Article ONE.

These three modes of acquisition are coordinate and of equal force, from which it must follow that "lines of railway, branches or extensions, or interests therein, *or other property*," will be free from the mortgage lien if acquired in any one of these modes. To be specific, equipment acquired by the railway company on its own credit would be free from the mortgage lien to the same extent as equipment acquired by the use of bonds issued under sections 2 and 3 of Article ONE. Such exclusion from the mortgage lien would exist in both cases, or it would not exist in either case. That it exists in the case of equipment acquired by the use of bonds issued under sections 2 and 3 of Article ONE may not be questioned. For the same reason the exemption must be held to exist in the case of equipment acquired by the railway company on its own credit. It is reasonable to believe that the free property clause

was intended by the parties to complement the scope of Granting Clause SECOND so as to include *all* after-acquired lines of railway, extensions and branches or other property, a part of which was to be subject to the mortgage lien if acquired by use of bonds issued under the mortgage except bonds issued under sections 2 and 3 of Article ONE, and the other part not subject to the mortgage lien if acquired in any other manner. There is no reason to suppose that the parties intended that the words "or other property" appearing in the so-called free property clause should have any different meaning than the description of the property listed in Granting Clause SECOND; and that description specifically names "rolling stock and other equipment".

But the suggestion is made that the words "or other property" in the free property clause, if those words include equipment, should be construed to include only that equipment, acquired by the railway company with free money, that is purchased for use on other lines of railway, branches or extensions that have been acquired with free money, and are not, therefore, subject to the mortgage lien. No such limitation or restriction is to be found in the free property clause. The suggestion mentioned has been advanced to support the claim that equipment acquired with free money, for use on railway lines subject to the mortgage, is subject to the mortgage lien; in other words, that such equipment constitutes after-acquired property which the mortgage has subjected to the mortgage lien.

The free property clause provides that nothing therein shall be construed to subject to the lien of the indenture "any hereafter acquired property of the Railway Company, * * * other than as *expressly* granted in the granting clause of this indenture, which shall be purchased, constructed, or acquired in any manner other than by use of bonds issued or to be issued under the provisions of Sections 4, 5 and 6, or any of them, of ARTICLE ONE of this indenture". Can it be said that after-acquired rolling stock and equipment is *expressly* granted in any of the

granting clauses of the indenture? The only description of after-acquired rolling stock and equipment to be found in the indenture, other than that applied to engines and cars acquired by the use of bonds issued under the indenture, is concentrated in the word "appurtenances" at the end of Granting Clause FIRST, VIII, and the words "property, real or personal," appearing in Granting Clause THIRD. The words "expressly granted" can mean only that the objects granted are directly and distinctly named or described—where identification of the objects is not dependent upon implication or inference. The word "appurtenances", or the words "property, real or personal", are far more comprehensive. The word "appurtenances" or the words "property, real or personal" may be applied to a variety of objects or things. To designate *expressly* any such appurtenance or item of property would require that the appurtenance or item be named. It is not apparent how after-acquired engines or cars can be said to be *expressly* granted by the use of the single word "appurtenances" appearing in the last clause of Granting Clause FIRST, VIII, which pledges "appurtenances . * * * appertaining or hereafter to appertain thereto", or by the use of the words "property, real or personal" appearing in Granting Clause THIRD.

There is no doubt that the parties intended to allow the Railway Company to obtain some equipment on its own credit free from the mortgage lien. The question here is *what* equipment? It is clear that later-acquired equipment for replacement purposes, and equipment so acquired by the use of mortgage bonds, was to become subject to the mortgage lien. It is not clear that equipment acquired by the railway company on its own credit, in excess of the equipment just defined, even if used on the lines subject to the mortgage, was to be subject to the lien. That conclusion has no firmer basis to support it than inferences to be drawn from general terms or expressions in the mortgage. If the parties had so intended, there were numerous specific words and sentences that could have been used

clearly to express such intention. Without clear expression of such intention it is not proper to supply it by judicial determination where the language in dispute can be otherwise applied.

All pertinent provisions of the mortgage should be reconciled and given effect. To repeat what is said herein when discussing the general gold bond mortgage, "the intention should not be left to be determined by conjecture or inference if two provisions or clauses, not harmonious on their face, can be reconciled by allocating to each a separate field of operation that will not be in conflict with the other". Equipment later acquired for replacement purposes, and equipment so acquired by the use of bonds issued under sections 4, 5 and 6 of Article One, was so-called after-acquired equipment the furnishing of which would satisfy the mortgage requirements relating to after-acquired equipment. The so-called free property clause comes into play and is given full meaning and effect according to its terms with respect to additional equipment to that just defined which the railway company elects to acquire by the use of its own credit, or by money that otherwise could be paid to its stockholders.

The First and Refunding Mortgage is entitled to credit against the "disputed equipment" (1) for so much of said equipment as was necessary on June 7, 1933, to replace any of the original equipment that was subject to a first lien under the indenture; (2) so much of said equipment as was necessary on that date to replace original equipment that was subject to a second or subordinate lien under the indenture, but which later became subject to a first lien under the indenture when a prior lien was discharged; (3) so much of said equipment as was necessary on that date to replace any equipment that was acquired by the use of first and refunding bonds issued under sections 4, 5 and 6, Article One, of the indenture; and (4) so much of the equity of the railway company as of June 7, 1933, in the then existing equipment trusts as might have been necessary on that date to satisfy clauses (1), (2) and (3) of this paragraph.

Leases:

Five leases are mentioned in the order referring the petition to a special master. The first lease, dated March 24, 1904, for a term of 999 years, is from Choctaw, Oklahoma and Gulf Railroad Company to the railway company. This lease is referred to as the Choctaw Lease. The other four leases are dated January 31, 1906, December 1, 1911, November 1, 1913, and February 1, 1914. They are mentioned in this proceeding as the R. I. A. L., The Rock Island and Dardanelle, Short Line, and Rock Island, Stuttgart and Southern leases. The provisions in each lease that are pertinent to the issue under the petition are identical. Therefore, it is sufficient to examine the Choctaw lease and determine the rights of the parties on the issue raised by the petition with respect to equipment affected by that lease.

Under the lease the lessor let, leased and demised, together with railway tracks, terminals, property and appurtenances therein described, all rolling stock and equipment of every description, including locomotives, cars and vehicles of every kind then owned or possessed, or which thereafter, during the term of the lease, might be acquired by the lessor, subject to certain mortgages and equipment trusts described in the lease.

Section Fifth of the lease provides:

> "The lessee will, during the term of this lease, keep and maintain the demised lines of railway of the lessor in good and proper condition for the passage thereover of both freight and passenger traffic, and shall and will keep and maintain in good repair, working order and condition the tracks, depots, terminal facilities and other demised property, using suitable materials for *renewal* of the same as *renewals* shall from time to time become necessary."

This provision governed the duty of the lessee during the continuance of the lease. It does not say that at all times the number of units of equipment in existence at the beginning of the lease must be maintained by replacement

if the volume of traffic should recede. The lessee would perform its duty by renewal of worn out or obsolete equipment only as such renewal might be necessary from time to time to care for the volume of traffic available, or, to use the language at the end of the provision quoted, "as renewal shall from time to time become necessary".

Section SEVENTH of the lease provides:

> "The lessee shall and will, at determination of this lease, re-deliver and surrender up to the lessor the demised premises and property in good order and condition, ordinary wear and tear excepted, with such additions, alterations and improvements as shall have been made thereto, subject, however, to any then existing encumbrances created by the lessor or by the lessee upon the demised premises or any part thereof, or upon the lessee's interest therein, and upon payment by the lessor to the lessee of the then value, over and above any and all such encumbrances, of all such additions, alterations and improvements, including equipment."

If the volume of traffic at the determination of the lease required a lesser number of units of equipment than the number taken over by the lessee when the lease was made, it would seem that the lessee, upon such determination, would perform its duty if it surrendered a sufficient number of units, in addition to all original units remaining, adequately to care for the volume of traffic at that time available. But on the other hand, if the volume of traffic at the determination of the lease required the same or greater number of units than the number taken over by the lessee when the lease was made, the lessee, upon such determination, would be required to surrender the same number of units as the number taken over when the lease was made, plus any excess number of units supplied by the lessee required for the larger volume of traffic, for which the lessor would be required to pay to the lessee the value of such excess number of units. The volume of traffic on June 7, 1933, was not less than the volume of traffic when the lease was made. It is not shown that the lessor has paid to the

lessee the value of any units of equipment furnished by the lessee in excess of the number of units taken over when the lease was made.

Attention is directed to the language of section SEVENTH which provides that surrender of the demised premises and property, with additions and improvements, shall be subject to encumbrances or liens created by the lessee upon the demised property or any part thereof, *or upon the lessee's interest therein,* upon payment by the lessor to the lessee of the then value, over and above any such encumbrances, of additions and betterments, including equipment. Loosely construed, this might imply that the lessee, during the term of the lease, could create liens upon the lessor's estate as it existed when the lease was made, and that the lessor would be bound thereby after termination of the lease. It is not to be supposed that the parties intended that the lessee might create a lien on the leased property beyond the lessee's interest therein, which would be the right to possess and use the property while the lease remained in effect. A rational construction of this paragraph would be that liens could be created by the lessee on additions and betterments added to the demised property and premises, and that upon surrender of such additions and betterments they would belong to the lessor, upon proper payment therefor, subject to the lien or liens so created. Examples of this would be an equipment trust created by the lessee to obtain equipment as additions or betterments on the lines of the lessor, or purchase money mortgages for land to be added to the demised premises.

The Choctaw lease granted to the lessee only the right to possess and use the Choctaw property. This right could be and was pledged under the first and refunding mortgage. But the pledge could not be more extensive than the right itself. The right to possess and use might expire at any time in case of default by the lessee, and in that event the right to use would cease to exist; and with the expiration of the right to use, the lien thereon would cease.

The lessor is entitled to credit against the "disputed equipment" (1) for so much of said equipment as was necessary on June 7, 1933, to replace any of the original equipment that was leased to the railway company; (2) so much of said equipment as was necessary on said date to replace equipment, if any, that was acquired subsequently to the date of the lease by the use of mortgage bonds of the lessor; and (3) so much of the equity of the railway company as of June 7, 1933, in then existing equipment trusts as might have been necessary on that date to satisfy clauses 1 and 2 of this paragraph.

Distribution of Credits:

The parties herein who may possess prior rights with respect to "disputed equipment" of the railway company are the trustee of the general gold bond mortgage, the trustee of the first and refunding mortgage, and the several lessors of lines of railway leased to the railway company.

For convenience, these terms may be used:

1. Original Equipment, meaning equipment in existence when mortgage or lease was made, and which at that time became subject thereto.

2. Original Cost, meaning cost at time of acquisition or construction.

3. Bond Equipment, meaning equipment acquired through the use of mortgage bonds.

4. Allocated Equipment, meaning equipment assigned to a mortgage to preserve the mortgage security, or to keep intact the equipment possession of which was transferred to the railway company under a lease.

5. Equity, meaning equity of the railway company as of June 7, 1933, in then existing equipment trusts.

The following determinations should be made from the records of the railway company:

(1) Original cost of "disputed equipment", less depreciation to June 7, 1933.

(2) General Gold Bond Mortgage: Original cost of original equipment, less depreciation to January 1, 1898, plus original cost of original equipment, if any, on which the mortgage was a subordinate lien which later became a first lien by reason of retirement of any prior mortgage lien thereon, less depreciation to the date when the mortgage became a first lien, plus original cost of bond equipment. Deduct from this, original cost of original equipment, less depreciation to June 7, 1933, plus original cost of bond equipment, less depreciation to June 7, 1933, plus original cost of allocated equipment, less depreciation to June 7, 1933, all of which equipment was still in service on June 7, 1933. Credit mortgage with the remainder and charge remainder against original cost of "disputed equipment", less depreciation to June 7, 1933.

(3) First and Refunding Gold Bond Mortgage: Original cost of original equipment upon which the mortgage was a first lien, less depreciation to April 1, 1904, plus original cost of original equipment, if any, on which the mortgage was a second lien which later became a first lien by reason of retirement of any prior mortgage lien thereon, less depreciation to the date when the mortgage became a first lien, plus original cost of bond equipment. Deduct from this, original cost of original equipment upon which the mortgage was a first lien, less depreciation to June 7, 1933, plus original cost of original equipment on which that mortgage was a second lien which later became a first lien by reason of retirement of any prior mortgage lien thereon, less depreciation from the date when the mortgage became a first lien to June 7, 1933, plus original cost of bond equipment, less depreciation to June 7, 1933, plus original cost of allocated equipment, less depreciation to June 7, 1933, all of which equipment was still in service

on June 7, 1933. Credit mortgage with the remainder and charge remainder against original cost of "disputed equipment", less depreciation to June 7, 1933.

(4) Original cost of original equipment under each lease, less depreciation to date of lease, plus original cost of equipment later acquired by the use of bonds issued under any mortgage of the lessor. Deduct from this, the original cost of original equipment, less depreciation to June 7, 1933, plus original cost of allocated equipment, less depreciation to June 7, 1933, plus original cost of lessor's bond equipment, less depreciation to June 7, 1933, all of which equipment was still in service on June 7, 1933. Credit lessor with remainder and charge remainder against original cost of "disputed equipment", less depreciation to June 7, 1933.

After these charges are made, any balance remaining of the original cost of "disputed equipment", less depreciation to June 7, 1933, plus the equity in equipment trusts, should be credited to claims of general creditors.

If the aggregate of these charges should exceed the original cost of the "disputed equipment", less depreciation to June 7, 1933, the excess should be charged against the equity in equipment trusts. In this event any balance of such equity should be credited to claims of general creditors.

If the aggregate of these charges should exceed the original cost of the "disputed equipment", less depreciation to June 7, 1933, plus the equity in equipment trusts, the respective charges should be proportionately reduced, in the ratio that each such charge bears to the total of such charges, to a combined amount equal to the original cost of the "disputed equipment", less depreciation to June 7, 1933, plus the equity in equipment trusts.

October 31, 1939.

SUPREME COURT OF THE UNITED STATES.

Nos. 7, 8, 20, 33 and 61.—October Term, 1942.

Frederick H. Ecker, John W. Stedman and Reeve Schley, constituting Institutional Bondholders Committee, Petitioners,
7 *vs.*
Western Pacific Railroad Corporation, A. C. James Co., The Railroad Credit Corporation, et al.

Crocker First National Bank of San Francisco and Samuel Armstrong, As Trustees Under the Western Pacific Railroad Company First Mortgage, dated June 26, 1916, Petitioners,
8 *vs.*
Western Pacific Railroad Corporation, The Western Pacific Railroad Company, Irving Trust Company, etc., et al.

The Western Pacific Railroad Company, Petitioner,
20 *vs.*
Frederick H. Ecker, et al.

Reconstruction Finance Corporation, Petitioner,
33 *vs.*
Western Pacific Railroad Corporation, A. C. James Co., et al.

Irving Trust Company, as Substituted Trustee Under the General and Refunding Mortgage of Western Pacific Railroad Company, Petitioner,
61 *vs.*
Crocker First National Bank of San Francisco, et al., etc.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[March 15, 1943.]

Mr. Justice Reed delivered the opinion of the Court.

Petitioners seek review of a decree of the Circuit Court of Appeals in the reorganization of The Western Pacific Railroad Company under Section 77 of the Bankruptcy Act. That decree reversed the order of the District Court which had approved the plan for reorganization certified to it by the Interstate Commerce Commission.[1]

The petitions for certiorari ask adjudication of questions which are important in the field of railroad reorganization. They involve the respective function of Commission and court, the method of

[1] Sec. 77, Bankruptcy Act, Reorganization of Railroads, 47 Stat. 1474, as amended, 11 U. S. C. § 205; In re Western Pac. R. Co., 124 F. 2d 136; In re Western Pac. R. Co., 34 F. Supp. 493; Western Pacific Railroad Company Reorganization, 230 I. C. C. 61; 233 I. C. C. 409; 236 I. C. C. 1.

valuation of railroad property by the Commission, the legality of the exclusion of stockholders and certain creditors from participation in the estate, a more favorable participation of a Reconstruction Finance Corporation claim because of new money furnished for the plan, allocation of securities among claimants, priorities of liens created by different mortgages and subsidiary issues. Heretofore this Court has not passed upon them. For their determination we granted certiorari. 316 U. S. 654.

The debtor railroad company filed its petition in the District Court for the Northern District of California on August 2, 1935, alleging its inability to pay and discharge its indebtedness as it matured and praying for reorganization under Section 77. The petition was approved as properly filed, trustees were appointed, their appointment ratified, 207 I. C. C. 793, and the appropriate steps taken to bring the plan of reorganization before the Commission for consideration. Public hearings were held by the Commission at which other plans for reorganization were filed, one by a group of bondholders known as the Institutional Bondholders Committee and one by the A. C. James Company, a secured creditor of the debtor which also was financially interested in the treatment accorded the preferred and common stock of the debtor. After full consideration of the problems of the debtor's reorganization and after the development of a plan deemed in accordance with Section 77, the Commission certified its plan to the District Court on September 28, 1939.

The Commission's conclusions and orders were reached upon exceptions to the report of its Bureau of Finance. Its plan was the outgrowth of a study of the financial condition and economic situation of the debtor, viewed in the setting of the public interest in a national transportation system. The competing claims of the various classes of creditors and stockholders were appraised in the light of the requirements of the Act that they be accorded fair and equitable treatment. There is little if any dispute concerning the primary facts from which factual or legal inferences are to be drawn.

The debtor is a California corporation with its principal operating office in San Francisco. It carries on an interstate railroad business between the States of California, Nevada and Utah.[2] For

[2] The summary of the debtor's property prepared by the Interstate Commerce Commission as of October 10, 1938, 230 I. C. C. 62, follows:

"*Location and general description of the property.*—The debtor owns or operates a total of 1,207.51 miles of standard-gage steam railroad. The main

an understanding of this opinion the obligations of the debtor as of January 1, 1939, the date proposed for the beginning of the operation of the plan, may be stated as follows:

Claim or Interest	*Principal of claim or interest*	*Accrued interest at contract rate to effective date of plan*	*Total claim including interest at contract rate to effective date of plan*
Trustees' Certificates (held by Reconstruction Finance Corporation)	$10,000,000.00	$.....	$10,000,000.00
Equipment obligations	2,750,050.00	94,202.00	2,844,252.00
First Mortgage 5% Bonds	49,290,100.00	13,143,776.66	62,433,876.66
Reconstruction Finance Corporation Collateral Notes (secured by $10,750,000 General and Refunding Mortgage bonds and other collateral*)	2,963,000.00	899,869.98	3,862,869.98
The Railroad Credit Corporation Collateral Notes (secured by $4,000,000 General and Refunding Mortgage bonds and other collateral*)	2,445,609.88	145,314.23	2,590,924.11
A. C. James Co. Collateral Notes (secured by $4,249,500 General and Refunding Mortgage bonds)	4,999,800.00	1,249,950.00	6,249,750.00
Total secured debt	$72,448,559.88	$15,533,112.87	$87,981,672.75
Unsecured Claims	5,818,791.00		
Preferred Stock	28,300,000.00		
Common Stock	47,500,000.00		
	$154,067,350.88		

*The "other collateral" does not belong to the debtor and is unaffected by the plan. See p. 38, *infra*.

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lines extend eastward 924.17 miles from Oakland, Calif., to Salt Lake City, Utah, and northward 111.81 miles from Keddie to Bieber, Calif., with operating rights over the Great Northern Railway, 46.38 miles, from Bieber to Hambone, Calif. The debtor also operates 4.2 miles of ferry service from Oakland to San Francisco, and 185.3 miles of second main track, of which 182.91 miles between Weso and Alazon, Nev., are owned by the Southern Pacific. This territory is known as the 'paired-track district,' since the two lines are used as a double-track railroad by both companies. Various branch lines springing from the Oakland-Salt Lake City line are as follows:

	Miles
Niles Junction to San Jose, Calif.	23.07
Calpine Junction to Calpine, Calif.	12.62
Hawley to Loyalton, Calif.	12.79
Reno Junction, Calif., to Reno, Nev.	33.11
Burmester to Warner, Utah	15.52
Miscellaneous	21.79
Total	118.90

Payment of this indebtedness was secured by liens, collateral or priority, as follows:

The trustees' certificates of $10,000,000 are secured by a lien on the entire estate and priority over all claims beyond reorganization expenses.

The equipment obligations of $2,750,050 are secured by rolling stock; acquired free of the liens of mortgages, through direct liens or trust arrangements. No one disputes the sound character of any of these securities. They are given priority over the fixed obligations of the reorganized company.

Subject to the trustees' certificates and equipment obligations, the first mortgage 5% bonds of $62,433,876.66, face and interest to the effective date of the plan, are secured by prior liens on all valuable property of the debtor, except (1) money, accounts, operating balances and cash items and (2) certain assets, referred to in the next paragraph, upon which the general and refunding bonds have a first lien, deemed by the Commission to be of value sufficient to support $732,010 of new income mortgage bonds and new preferred stock of $1,147,955 par. The total face and assumed value of the securities authorized by the plan, as evidence of the entire value of the system, is $84,000,000 plus. See page 23 *infra.* This paragraph reflects our conclusions as to priorities of the liens of the respective mortgages later discussed. See *Priorities of Conflicting Liens*, page 28 *infra.*

The later general and refunding mortgage bonds, $18,999,500 in face amount, are secured by a first lien on properties determined

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"*Owned or controlled and jointly affiliated railroad companies.*—The debtor owns all the outstanding capital stock of the Sacramento Northern Railway, an electrically operated standard gage freight and passenger railroad, consisting of 276.2 miles of road serving and connecting San Francisco and Oakland with various Sacramento Valley cities, principally Pittsburg, Vacaville, Sacramento, Woodland, Marysville, Colusa, and Oroville, all in California.

"By ownership of more than 99 percent of the outstanding capital stock, the debtor controls the Tidewater Southern Railway, which operates a standard gage steam freight line 61.38 miles in length, connecting Stockton with Manteca, Escalon, Modesto, and Turlock in the San Joaquin Valley of California.

"The debtor owns all the outstanding capital stock of the Deep Creek Railroad Company, which owns and operates a standard gage steam railroad extending from Wendover to Gold Hill, Nev., a distance of 44.6 miles. In addition it owns 50 percent of the capital stock of the Salt Lake City Union Depot & Railroad Company; 33 1/3 percent of the capital stock of the Central California Traction Company, operating an electrically operated freight railroad extending from Stockton to Sacramento, Calif., with a road mileage of 53.78 miles; and 50 percent of the capital stock of the Alameda Belt Line, operating 15.86 miles of terminal switching line in the city of Alameda on San Francisco Bay.

"None of the above subsidiary or affiliated companies has filed a petition under section 77 of the Bankruptcy Act, as amended."

by the Commission to be of a value and earning power sufficient to support issues of new income bonds and participating preferred stock of $732,010 and $1,147,955, respectively. See 233 I. C. C. 414, *et seq.* They are further secured, subject to the prior rights and other exceptions of the obligations listed in the preceding paragraphs, by a lien on all valuable property of the debtor. All of this series which were issued are pledged to secure the collateral notes in the amounts indicated in the preceding table.

By reason of an arrangement with the Reconstruction Finance Corporation, detailed later in the section of this opinion headed *Allocation of Securities*, B, page 25, *infra*, the distribution of securities to creditors did not reflect absolutely their priority position. The collateral notes owned by the R. F. C. were treated in the distribution of securities on the same basis as were the claims of old First bondholders. The result is summarized by the table on page 8 and footnotes 5 and 6.

By stipulation of the parties, the record shows that the value of the property of the debtor and its subsidiaries, "as found by the Interstate Commerce Commission under Section 19(a) of the Interstate Commerce Act, with additions and betterments, new lines and extensions, subsequent to date of valuation, plus non-operating properties," was $150,907,623.49 as of December 31, 1938. It is further stipulated that there is no deferred maintenance in the debtor's properties. "Its facilities and equipment are sufficient to handle expeditiously and efficiently all traffic reasonably to be anticipated in the immediate future." The value of the debtor's system, with equipment depreciated, was $144,978,559 as of December 31, 1938.

There is agreement as to the amount of system earnings available for interest for 1922 to 1939, inclusive. The amounts follow:[3]

Adjusted Consolidated Earnings Available For Interest

1922 —	$2,404,890	1928 —	$4,376,972	1934 —	$1,396,353
1923 —	3,412,234	1929 —	3,718,436	1935 —	1,377,026
1924 —	3,241,823	1930 —	2,381,529	1936 —	1,901,423
1925 —	4,557,798	1931 —	220,494 (deficit)	1937 —	1,077,407
1926 —	4,868,890	1932 —	283,912	1938 —	225,431
1927 —	3,470,861	1933 —	474,365	1939 —	1,519,916

It is to be borne in mind that while these figures represent net income of the system, as shown by its combined income account,

[3] These figures represent reported consolidated earnings "adjusted to take into account (a) rehabilitation expenditures in the years 1927-1931 and 1934-1938, (b) amortization of discount on First Mortgage Bonds of the Debtor in the years 1922-1938, and (c) deductions and credits in the years 1931-1934 made by the Commission to accord with its Accounting Rules and Regulations, . . ."

adjusted as indicated, factors other than the net income result were placed before and weighed by the Commission and the District Court. Of course the fluctuating operating revenues for the periods from freight, passenger, mail, express, victualing and miscellaneous were considered, as well as the corresponding labor, power, tax, rental and miscellaneous expenses. Operating ratio percentages for the various years are available in the evidence.

The stipulated operating revenues of the debtor's system for the years 1922-1938 and the first nine months of 1939 are as follows:

1922 —	$12,736,564	1928 —	$19,421,851	1934	— $13,779,238
1923 —	14,414,812	1929 —	20,096,557	1935	— 14,407,458
1924 —	14,669,313	1930 —	18,819,062	1936	— 16,547,344
1925 —	15,898,548	1931 —	14,852,938	1937	— 17,918,485
1926 —	17,951,468	1932 —	12,251,071	1938	— 16,057,451
1927 —	18,306,675	1933 —	12,202,489	1939 (1st 9 mths.)	— 12,836,985

Furthermore, the record shows the favorable effect upon the system's gross operating revenue of the extension of its lines into Northern California. This new construction, known as the Northern California Extension, was put into operation in 1932 and contributed the following gross revenues from freight originating, terminating and passing over the extension:

1932.....	$1,098,016	1936	$3,151,734
1933.....	1,491,466	1937	3,425,601
1934.....	2,119,427	1938	3,093,674
1935.....	2,289,858	1939 (first 9 months)	2,463,489

The extension is a link in a Pacific coast route created by this northerly extension and a corresponding southerly extension by the Great Northern Railroad Company which join at Bieber, California. The extension cost over ten million dollars and was built with the expectation, since realized, of materially increasing the value of the debtor's property as an operating road. The Commission gave consideration to this factor in estimating the probabilities of future income.

Prospects for maintaining and increasing the debtor's traffic and so its net for interest and dividends are influenced by the fact that it depends to a considerable extent upon traffic arrangements with other lines. The debtor's main line from Oakland, California, to Salt Lake City is an important section of a through route from the Pacific coast to the Midwest. In conjunction with the Denver & Rio Grande Western and the Missouri Pacific Railroad Company it offers fast through schedules. The Denver & Rio Grande Western completed, in 1934, the Dotsero Cut Off. This Cut Off and the

Moffatt Tunnel, a nearby improvement of the Denver and Salt Lake, used together materially shorten the railroad distance between Pacific coast and Midwest points and open to passenger traffic a scenic route of great beauty. The hearings on reorganization make these facts as to the likelihood of increased traffic available to the Commission and court.

These basic factors of physical condition, traffic, gross and net income et cetera were before the Commission and the courts. From them there was to be projected an estimate as to the future from which was to be drawn a present valuation of the property and its ability to carry by its earnings a certain volume in dollars of securities. There are no assets of significant worth which are not in active use as producers of income. Relying largely upon past earnings, the Commission found "that the fixed interest charges of the reorganized company should not initially and substantially exceed $500,000, if the reorganized company is to maintain its property properly and secure necessary new capital in the future." It further determined that the plan should provide a capital fund for future routine additions and betterments. This was estimated to require $500,000 annually.[4] Carrying charges of $94,202 on existing equipment trusts were to be assumed by the reorganized corporation. A new $10,000,000 first mortgage 4% bond issue was allotted $400,000 annually. These fixed charges aggregate $994,202. In addition to the fixed charges, the Commission determined the system reasonably could carry another $1,000,000 of contingent charges. Thus the over-all charge for annual fixed and contingent interest, capital and sinking funds was limited to approximately $2,000,000 per annum. Income mortgage 4½% bonds were authorized in the amount of $21,219,075. Their annual interest comes to $954,858 and their one-half per cent sinking fund calls for $106,095.

In view of the foregoing limitation, capitalization of the reorganized company was fixed at $2,750,050 of undisturbed equipment obligations, $10,000,000 of first mortgage 4% bonds, $21,219,075 of income mortgage 4½% bonds, $31,850,297 of 5% preferred stock, and 319,441 shares of common stock without par

[4] 230 I. C. C. 91: "Annual payments into the fund should be $500,000 or such lesser sum as may be required, together with unappropriated accumulations in the fund as of the close of the calendar year prior to that for which the payment is to be computed, less charges for additions and betterments during the latter year, to bring the total in the fund to $1,000,000."

value.[5] These issues of preferred and common were based upon possible earnings in addition to the $2,000,000 plus. These securities were allotted by the Commission upon consideration of "the relative priority, value, and equity of the various claims and the value of the new securities available in exchange therefor," as follows:[6]

	New First Mortgage 4% Bonds Series A	*New Income Mortgage 4½% Bonds Series A*	*New 5% preferred Stock Series A ($100 Par)*	*New Common Stock (No Par)*
First Mortgage 5% Bonds ($62,433,876.66)		$19,716,040	$29,574,060	230,593 shs.
RFC (In exchange for Trustees' Certificates of $10,000,000 and Collateral Notes of $3,862,869.98)	$10,000,000	1,185,200	1,777,800	15,788 shs.
RCC Collateral Notes ($2,590,924.11)		154,111	241,681	35,425 shs.
ACJ Collateral Notes ($6,249,750)		163,724	256,756	37,635 shs.
Totals	$10,000,000	$21,219,075	$31,850,297	319,441 shs.

[5] 233 I. C. C. 409, 413; 236 I. C. C. 1, 4. This is summarized by a petitioner as follows:

Title of Issue	*Presently to be issued*	*Annual Charges*
Undisturbed existing equipment obligations	$2,750,050	$94,202
First Mortgage 4% Bonds, Series A, due January 1, 1974	10,000,000	400,000
Total annual fixed charges		$494,202
Mandatory Capital Fund		500,000
Income Mortgage 4½% Bonds, Series A, due January 1, 2014. Interest cumulative to 13½%, otherwise noncumulative. Convertible at the option of the holder into new Common Stock at the price of $50 per share	21,219,075	954,858
Total funded debt	$ 33,969,125	
Total annual charges (fixed and contingent) and Capital Fund		$1,949,060
Income Mortgage Sinking Fund (½%)		106,095
Participating 5% Preferred Stock ($100 par value)	31,850,297	1,592,515
Total securities with par value	$65,819,422	
Total annual charges, Capital Fund, and Preferred dividend requirements		$3,647,670
Common Stock (without par value)	319,441 shs.	

[6] The applicable portion of the finding is as follows:

"(1) First-mortgage bondholders, $19,716,040 of income-mortgage bonds, $29,574,060 of preferred stock, and 230,593 shares of common stock, the common stock to be taken at the price of $57 a share; (2) Finance Corporation, $1,185,200 of income-mortgage bonds, $1,777,800 of preferred stock, and 15,788 shares of common stock, the common stock to be taken at a price of

The Commission found, correlative to and as a basis for its allocation of securities, that "the equity of the existing stock has no value, and hence holders of such stock are not entitled to participate in the plan. Further, considering that the reorganized company's income available for interest and dividends must total $4,318,035,[*] plus any undistributed profits tax that will be payable, before dividends of $3 per share may be paid on the new common stock, it is clear that even though all the securities remaining available for distribution after satisfying the claims of the first-mortgage bondholders are allotted to the other secured creditors, such securities will be inadequate in value to satisfy their claims. For this reason, and for the reasons stated with respect to the finding that the equity of the existing stock has no value, we find that the claims of the unsecured creditors, of the Western Pacific Railroad Corporation, and of the Western Realty Company, have no value, and hence no securities or cash should be distributed under the plan in respect to those claims." 230 I. C. C. 101.

The plan and a transcript of the proceedings before the Commission were duly certified to the District Court. *Re Western Pac. R. Co.*, 34 F. Supp. 493, 495. The plan in complete form and a detailed discussion of the history, property and business prospects of the debtor appears in the various reports of the Commission and the opinion below. See note 1 *supra*. The District Court heard the protests against the action of the Commission and the additional evidence offered, and found that the plan conformed in all respects to the requirements of Section 77.[7] All objections to the plan were therefore overruled and the court di-

$57 a share; (3) Credit Corporation, $154,111 of income-mortgage bonds, $241,681 of preferred stock, and 35,425 shares of common stock, the common stock to be taken at a price of $62 a share; and (4) James Company, $163,724 of income-mortgage bonds, $256,756 of preferred stock, and 37,635 shares of common stock, being the amount of common stock which bears to the amount of common stock allotted to the claim of the Credit Corporation the same proportion that the principal amount of general and refunding bonds of the debtor held by the James Company as collateral for its claim bears to the principal amount of such bonds held by the Credit Corporation for its claim." The result of the distribution per dollar of indebtedness is set out in the Commission's reports. 230 I. C. C. 101 and 233 I. C. C. 417 and 451.

[*] This amount now is somewhat larger on account of increased face of securities. 233 I. C. C. at 412.

[7] For the purposes of this controversy, the apposite requirements of Section 77, 11 U. S. C. § 205, may be excerpted as follows:

"(b) A plan of reorganization within the meaning of this section (1) shall include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions

rected that a copy of the order and opinion be transmitted to the Commission for use in submitting the plan for action to the first mortgage bondholders, the R. F. C., the A. C. James Co. and the Railroad Credit Corporation; the only creditors found to be entitled to vote on the adoption of the plan.

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modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, interest on unfunded debt, amortization of discount on funded debt, and rent for leased railroads) in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; (5) shall provide adequate means for the execution of the plan, ...

. . . . . .

"(d) The debtor, after a petition is filed as provided in subsection (a) of this section, shall file a plan of reorganization within six months of the entry of the order by the judge approving the petition as properly filed, . . . After the filing of such a plan, the Commission, unless such plan shall be considered by it to be prima facie impracticable, shall, after due notice to all stockholders and creditors given in such manner as it shall determine, hold public hearings, at which opportunity shall be given to any interested party to be heard, and following which the Commission shall render a report and order in which it shall approve a plan, which may be different from any which has been proposed, that will in its opinion meet with the requirements of subsections (b) and (c) of this section, and will be compatible with the public interest; or it shall render a report and order in which it shall refuse to approve any plan. In such report the Commission shall state fully the reasons for its conclusions.

" . . . No plan shall be approved or confirmed by the judge in any proceeding under this section unless the plan shall first have been approved by the Commission and certified to the court. . . .

"(e) Upon the certification of a plan by the Commission to the court, the court shall give due notice to all parties in interest of the time within which such parties may file with the court their objections to such plan, and such parties shall file, within such time as may be fixed in said notice, detailed and specific objections in writing to the plan and their claims for equitable treatment. The judge shall, after notice in such manner as he may determine to the debtor, its trustee or trustees, stockholders, creditors, and the Commission, hear all parties in interest in support of, and in opposition to, such objections to the plan and such claims for equitable treatment. After such hearing, and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; . . .

"If the judge shall not approve the plan, he shall file an opinion, stating his conclusions and the reason therefor, and he shall enter an order in which he may either dismiss the proceedings, or in his discretion and on motion of any party in interest refer the proceedings back to the Commission for further

On appeal to the Circuit Court of Appeals, Judicial Code § 128, 43 Stat. 936, this order was reversed. The court rested upon the necessity of specific valuation of the entire property, of the respective portions of it covered by the First Mortgage and the Refunding Mortgage, of each of the claims and of the new securities allocated to the creditors. Such action was deemed essential to enable the District Court to exercise its independent judgment upon matters of valuation and allocation. The failure to make

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action, in which event he shall transmit to the Commission a copy of any evidence received. . . . . If the judge shall approve the plan, he shall file an opinion, stating his conclusions and the reasons therefor, and enter an order to that effect, and shall send a certified copy of such opinion and order to the Commission. The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirement of subsection (c) of this section, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such time as the Commission shall specify, together with the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided*, That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that at the time of the finding the corporation is insolvent, or that at the time of the finding the equity of such class of stockholders has no value, or that the plan provides for the payment in cash to such class of stockholders of an amount not less than the value of their equity, if any, ... *Provided further*, That submission to any class of creditors shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by the plan, or that at the time of the finding the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests. . . .

. . . . . .

"If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts.

"(f) . . . The property dealt with by the plan, when transferred and conveyed to the debtor or to the other corporation or corporations provided for by the plan, or when retained by the debtor pursuant to the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, and the debtor shall be discharged from its debts and liabilities, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, and the judge may require the trustee or trustees appointed hereunder, the debtor, any mortgagee, the trustee of any obligation of the debtor, and all other proper and necessary parties, to make any such transfer or conveyance, and may require the debtor to join in any such transfer or conveyance made by the trustee or trustees. . . ."

such separate valuations was held to require the setting aside of the District Court's approval of the plan. See note 26, *infra*.

Function of the Court. The conclusion of the Court of Appeals as to the necessity for a detailed valuation springs from its interpretation of the statute as to the function of the District Court in reorganizations. That court had said in its opinion:

"It cannot be gainsaid that the Commission knows all about the Debtor, its property, its history, financial and otherwise, its traffic and revenue, and its financial structure. No official body in the country is better qualified, by reason of experience, ability and specialized knowledge than is the Commission to find the ultimate facts as to the Debtor in relation to any of the matters mentioned." *In re Western Pac. R. Co.*, 34 F. Supp. 493, 501.

Commenting upon this, the Court of Appeals said:

"The statement indicates a possible misconception. . . .

"In determining whether a plan of reorganization satisfies the requirements of subsection e, the court is not concluded by any determination made by the Commission, but may, and must, exercise its own independent judgment; and this is true whether such determination relates to value or to some other subject. Initially, however, the duty of determining the value of any property for any purpose under § 77 rests on the Commission, not on the court." *In re Western Pac. R. Co.*, 124 F. 2d 136, 140.

Petitioners in Nos. 7, 8 and 33 seek review of this last ruling. Their petitions for certiorari query whether Section 77 does not vest

"in the Commission exclusive jurisdiction (subject only to review for arbitrary exercise) to determine whether a railroad reorganization plan is 'compatible with the public interest', including jurisdiction to determine total capitalization, the classification thereof, and the financial details of each class of proposed capitalization?"

This summary sufficiently identifies the issue without the necessity of elaborating differentiations in the petitioners' present views or of determining the degree of difference between the views of the district and appellate courts as to the function of the court under § 77.

The opinion shows the attitude of the District Court, 34 F. Supp. 493, 503, 504: "The capitalization permitted by these earnings is a mere matter of computation, which will demonstrate that the Commission did not act arbitrarily in limiting capitalization nor the respective classes thereof. . . ."

"The determination of the amount and character of the capitalization (a legislative function affecting the public interest) is

exclusively within the province of the Commission. The only qualification, if any, is that the court shall independently determine whether, in the exercise of its jurisdiction, the Commission has acted fairly, within the bounds of the Constitution, and not arbitrarily." Upon the other findings of the Commission, the District Court exercised an independent judgment based upon the record and the findings of the Commission together with additional evidence produced before the court by the parties. 34 F. Supp. 493, 505.

These reorganizations require something more than contests between adversary interests to produce plans which are fair and in the public interest. When the public interest, as distinguished from private, bulks large in the problem, the solution is largely a function of the legislative and administrative agencies of government with their facilities and experience in investigating all aspects of the problem and appraising the general interest.[8] Congress outlined the course reorganization is the follow. It established standards for administration and placed in the hands of the Commission the primary responsibility for the development of a suitable plan. When examined to learn the purpose of its enactment, Section 77 manifests the intention of Congress to place reorganization under the leadership of the Commission, subject to a degree of participation by the court.

It is clear from the discussions and the statute itself that there was recognition by everyone of the advantages of utilizing the facilities of the Commission for investigation into the many sided problems of transportation service, finance and public interest involved in even minor railroad reorganizations and utilizing the Commission's experience in these fields for the appraisals of values and the development of a plan of reorganization, fair to the public creditors and stockholders.[9] The resulting legislation was an attempted balance between the power of the Commission and that of the court.

As to the court's place in reorganization, the present statute does not vary greatly from the first legislative effort, enacted

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[8] Cf. Hearings on H. R. 7432, House Committee on Interstate & Foreign Commerce, 72d Cong., 2d Sess. (1933), pp. 11-12; Cushman, The Independent Regulatory Commissions (1941) 45-58.

[9] The need for railroad rehabilitation legislation under the bankruptcy clause of the Constitution was generally recognized. President's Message, January 11, 1933, 76 Cong. Rec. 1615; 46th Annual Report of the I. C. C., Dec. 1, 1932, p. 15; for a statement that the President-elect favored the legislation, see 76 Cong. Rec. 2917.

March 3, 1933, to reorganize railroads unable to meet their obligations.[10] The amendments of 1935 were primarily designed to cure defects disclosed by practical experience.[11] Both acts are bottomed upon the theory of debtor rehabilitation by adjustment of creditors' claims. Such treatment was essential for embarrassed railroads, as ordinary bankruptcy liquidation or judicial sales were impossible because of the size of their indebtedness and the paucity of buyers. The acts were a part of the relief granted financially involved corporations, public and private, in the depression years of the early thirties.[12] Since railroads could not take advantage of the Bankruptcy Act, § 4, 11 U. S. C. § 22, their financial adjustments for years had been carried out in equity receiverships under judicial control. These were cumbersome, costly and privately managed with inadequate consideration for the public interest in a soundly financed transportation system. *Chicago, Milwaukee & St. Paul Investigation*, 131 I. C. C. 615, 671; *United States* v. *Chicago, etc. R. Co.*, 282 U. S. 311, 331 dissent.

The first bill was introduced in the House January 21, 1933, as H. R. 14359.[13] It was drafted so as to place "the entire plan of reorganization under the jurisdiction, supervision and control" of the Commission. After Commission approval, which followed stockholder and creditor approval, it was to transmit the "approved plan, its findings and the record to the court. The court's review must be based upon the record made before the Commission."[14] This substitution of the Commission for an equity receivership under court direction was criticized and amendments suggested to "eliminate all confusion in regard to the functions to be exercised by the commission and by the court. . . . and [to] remove the most fundamental objections to the bill in its present form."[15] Notwithstanding the criticism the bill passed the House with the power lodged in the Commission, as originally

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[10] The section was extensively revised in 1935. Compare 47 Stat. 1474 with 49 Stat. 911.

[11] H. Rep. No. 1288, 74th Cong., 1st Sess., p. 1; S. Rep. No. 1336, 74th Cong., 1st Sess., p. 1.

[12] For the twelve months ending Sept. 30, 1932, operating revenues of Class I railroads were $3,321,052,031, a decline of $915,535,318 below those of the calendar year 1931 and about equal to those of the year 1915. 46th Annual Report of the Interstate Commerce Commission, Dec. 1, 1932, p. 6. Cf. 48 Stat. 912, 798.

[13] 76 Cong. Rec. 2905.

[14] H. Rep. No. 1897, 72d Cong., 2d Sess., pp. 6-7. Subsections (d) & (g), H. R. 14359, 76 Cong. Rec. 2905, 2906.

[15] Solicitor General's Memorandum, 76 Cong. Rec. 2771, 2773.

proposed. When the House bill for the relief of debtors.[16] was reported by the Senate Committee, the railroad section was omitted. By a motion from the floor it was reinstated but in a changed form. The Senate adopted changes designed to give more power to the court. 76 Cong. Rec. 4907, 5104-34. Hearings before the court were provided. The judge, it was added, was to be "satisfied that (1) the approved plan complies with the provisions of subsection (b) of this section, is equitable and does not discriminate unfairly in favor of any class of creditors or stockholders."[17] These amendments giving concurrent powers to the court were adopted by the Senate and accepted by the House and the bill became the Act of March 3, 1933, 47 Stat. 1474.

Following the recommendation of the President in his message of June 7, 1935, the Congress adopted amendments to the 1933 act which were in line with the suggestions of the Federal Coordinator of Transportation and the Commission.[18] While the most important amendment was to furnish means to avoid the obstruction of dissatisfied classes of creditors or stockholders by making a fair and equitable plan effective over dissenters, the requirement of coordinated action by Commission and court was retained.

The Senate Report, No. 1336, 74th Cong., 1st Sess., concluded:

"The amendments to section 77 leave unimpaired the power and the duty of the commission and the courts to deal with the most important feature of all reorganization plans, that of the control of the reorganized company; and similarly the commission and courts will continue to have the power and authority of making that thorough investigation which is necessary to assure sound and reliable control for bankrupt companies when they emerge from the courts, in place of the type of control under which some railroads have been wrecked."

Under the present statute the District Court has definite responsibility in reorganization. Subsection (e). After the certification from the Commission is filed, a hearing is authorized at which all interested parties may appear. Additional evidence of opponents and proponents of the plan may be received upon "detailed and specific objections in writing to the plan and their claims for

[16] The bill dealt with the subject matter of what are now Chapters 8-11 of the Bankruptcy Act.

[17] Subsection (g), 47 Stat. 1479. The provisions of subsection (b) were then substantially like they are now.

[18] 79 Cong. Rec. 8851. H. Rep. No. 1283, 74th Cong., 1st Sess., p. 1; compare draft of Coordinator's proposals, Report of the Federal Coordinator of Transportation (1935), H. Doc. No. 89, 74th Cong., 1st Sess., p. 229.

equitable treatment". The judge shall then "approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders;" and if satisfied as to fees, costs and allowances. If the plan is disapproved, the proceedings may be dismissed or referred back to the Commission for further consideration. On approval by the judge the plan is returned to the Commission for submission to stockholders and creditors for their approval. Submission to classes of stockholders or creditors may be omitted on a finding by the Commission, affirmed by the judge, of a lack of value in the equity of the stockholders or the claims of the creditors. On certification of the results of the submission the judge shall confirm the plan finally, if satisfied the requisite approval has been obtained or is excused for reasons stated in subsection (e). The judge is not empowered to approve or confirm any plan until it has first been approved by the Commission and certified to the court. Subsection (d).

The power of the court does not extend to participation in all responsibilities of the Commission. Valuation is a function limited to the Commission, without the necessity of approval by the court. The first sentence of the last paragraph of subsection (e) provides:

"If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan."

The function of valuation thus left to the Commission is the determination of the worth of the property valued, whether stated in dollars, in securities or otherwise. One of the primary objects of the bill was the elimination of obstructive litigation on the issue of valuation[19] and the form finally chosen approached as near to that position as seemed to the draftsmen legally possible. Judicial reexamination was not considered desirable.[20] None of

[19] Report of the Federal Coordinator, *supra*, n. 18, pp. 100-103; H. Rep. No. 1283, 74th Cong., 1st Sess., p. 3; S. Rep. No. 1336, 74th Cong., 1st Sess., p. 3; Hearings on H. R. 6249, House Committee on the Judiciary, 74th Cong., 1st Sess., Ser. 3, April 15-25, 1935, pp. 26-31.

[20] Cf. Hearings on H. R. 6249, *supra* n. 19, pp. 249-50, 291-92, 317.

the findings required of the judge under subsection (e) relate specifically to valuation. Congress apparently intended to leave the determination of valuation "of any property for any purpose under this section" to the Commission.[21] The language chosen leaves to the Commission, we think, the determination of value without the necessity of a reexamination by the court, when that determination is reached with material evidence to support the conclusion and in accordance with legal standards. It leaves open the question of whether in reaching the result the Commission had applied improper statutory standards. This latter point is discussed under the heading of ***Method of Valuation*** in this opinion, p. 20 *infra*, where this plan is reviewed and upheld in this respect.

Another restriction on court action is that the determination as to whether the plan is "compatible with the public interest" rests, as valuation does, with the Commission. Subsection (d). Without attempting to forecast the limits of the phrase as used in the setting of this statute, it is sufficient in this case to determine, as we do, that it includes the amount and character of the capitilization of the reorganized corporation. Cf. *N. Y. Central Securities Co.* v. *United States*, 287 U. S. 12, 24. Leaving the problems of public interest to the Commission was not a departure from precedent. The phrase had been employed long before in the grant of authority to supervise the issue of securities. Section 20a, Interstate Commerce Act.[22]

The problems of capitalization are of public interest. The corporate form is universally used for the business of railroading. Railroad securities are widely distributed in investment portfolios

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[21] The bill as recommended by the Federal Coordinator of Transportation, H. Doc. 89, *supra*, n. 18, p. 238, and in a different form as considered by the Committee on the Judiciary of the House, Hearings on H. R. 6249, *supra*, n. 19, p. 8, did not contain the quoted sentence. During the hearings, the Chairman sought advice as to whether it would be legally valid to make the valuation of the Commission final in practice. This was not denied although doubt was expressed whether the Commission's finding could preclude a certain limited amount of judicial review. See Hearings on H. R. 6249, *supra* n. 20. After this discussion, the bill which was to pass the House was introduced on June 20, 1935, 79 Cong. Rec. 9814. It contained the quoted sentence, above referred to, in the form as it now appears in subsection (e).

[22] "The commission shall make such order only if it finds that such issue or assumption: (a) is for some lawful object within its corporate purposes, and compatible with the public interest, which is necessary or appropriate for or consistent with the proper performance by the carrier of service to the public as a common carrier, and which will not impair its ability to perform that service, and (b) is reasonably necessary and appropriate for such purpose." 49 U. S. C. § 20a(2).

and among individual savers. The reasonable earning power of securities, the terms and conditions of the respective issues and the soundness of the aggregate capitalization affects the public interest immediately and directly. Capitalization is an essential factor bearing on an efficient transportation system for shipper, investor and consumer. The development of the capitalization of the reorganized company which is entrusted solely to the Commission under the requirement that the plan be compatible with the public interest is that relating to the total amount of issuable securities and the quality of the securities to be issued. So long as legal standards are followed, the judgment of the Commission on such capitalization is final.

Thus limited the district court acts concerning the plans only upon the issues specifically delegated by subsection (e). As to these, its powers are negative. It may veto the plan in its entirety but may improve it only by suggestion. It becomes a necessary and important factor in railroad reorganization. These reorganizations may be attained only through properly coordinated action between the Commission and the court.[23] In this case we are of the view that the District Court performed its required functions in accordance with the requirements of the statute. See page 12, *supra*.

Amount and Character of Capitalization. While the public interest phase of capitalization is not to be independently passed upon by the court, the court does have statutory authority to review for obedience to legal standards.[24] Petitioners in seeking certiorari and now on the merits concede that the exclusive power in the Commission to pass upon the amount and character of capitalization is subject to review for "arbitrary exercise." The respondent A. C. James Company makes the point that the restriction of the amount of capitalization to an aggregate limited by the reasonable probability of a fair return deprives those creditors and stockholders who are barred as holding claims without value, of their property interest in the debtor without due process and contrary to the mandate of Section 77. The Commission thought that the public interest required a capital structure

[23] Cf. Palmer v. Massachusetts, 308 U. S. 79, 87; Warren v. Palmer, 310 U. S. 132, 138; United States v. Morgan, 307 U. S. 183, 191; Report of President's Committee to Submit Recommendations upon the General Transportation Situation, Dec. 23, 1938, p. 25.

[24] See Opp Cotton Mills v. Administrator, 312 U. S. 126, 144.

which would give the reorganized company "a reasonable opportunity to function efficiently and continuously" and that "proposed charges, whether fixed or contingent, shall be within its probable earning power." 230 I. C. C. at 87.

Assuming at this point that the Commission's valuation is sound and reached by allowable methods, a matter discussed later in this opinion at page 20, we hold that the elimination of the claims of stockholders and creditors which are valueless from participation in the reorganization is in accordance with valid provisions of section 77(e).[25] Actual bankruptcy means a loss to some investors. Subsection (e) recognizes this inevitable result and provides a method for their elimination from the reorganization proceedings. After all of the reasonable value had been exhausted by senior securities, warrants might have been authorized for otherwise unsatisfied claims. Such warrants would represent merely the possibility of recoupment, just as the equity of redemption in judicial sales. But there is no constitutional or statutory requirement that such immediately valueless paper should be issued. A mere possibility that traffic might be found to the limit of the physical capacity of the system is not the kind of earning power which justifies the issue of securities based upon such a possibility. Whatever may be the limits of the power of the Commission to find claims worthless, the present plan may not be successfully attacked on the ground that Congress is powerless to authorize in bankruptcy the elimination of claims without value. *In re 620 Church St. Corp.*, 299 U. S. 24.

Nor do we find violation of legal standards in the requirement by the Commission for a capital fund or the issue of stock to former holders of interest bearing securities. The Commission is charged with the development of a plan which must balance and choose between public and private interests. The evidence before the Commission gave grounds for the finding of a normal requirement of an annual $500,000 fund for improvements. It is reasonable to agree with the Commission that a substantial share of the securities should be fixed stock investments rather than that the entire aggregate amount, justified by estimates of probable earnings, should be in interest bearing loans, which ultimately must be redeemed. Stock which has no retirement provisions is the backbone of a corporate structure.

[25] Such a result was within the contemplation of the Congressional committee. Hearings on H. R. 6249, *supra*, n. 19, pp. 26, 80, 107, 118, 227, 255, 278.

Method of Valuation. While by the terms of the statute the valuation of the property is left to the Commission, without participation by the court, this valuation must be made in accordance with the direction of the statute and as to that valuation is subject to judicial review. This review is limited in character by the direction of subsection (e) that valuation shall be determined by the Commission. The District Court may review to determine whether the Commission has followed the statutory mandates of subsection (e). Subsection (e) requires valuations by the Commission to be "determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts." Thus, while judicial review does not involve an independent examination into valuation, it does require that the court shall be satisfied, upon the record before the Commission, with such additional evidence as may be pertinent to the objections to the Commission's finding of value, that the statutory requirements have been followed.

An example of this type of review occurs in this record. The Irving Trust Company as Refunding Mortgage Trustee in Nos. 7 and 8 and the A. C. James Company object to the finding of the Commission that the bonds, $270,000, and stock, $360,834. par value, of the Central California Traction Company and $465,300, par value, of the capital stock of the Alameda Belt Line, pledged only under the Refunding Mortgage, had no material value. 233 I. C. C. 414-416. These securities were owned solely by the debtor but in the case of the first company represented a one-third interest in the Traction Company and in the case of the second a one-half interest in the Belt Line. Competing transcontinental railroads owned the other interests. The respective ownerships were acquired to put the debtor in a position to obtain its fair share of the business from and to these feeder lines. The facts before the Commission showed that over the preceding decade, the debtor had contributed annually substantial sums to meet the deficits of each of the companies. It was shown in the District Court that each of the companies were useful auxiliaries to the business of the debtor. However, valuation is essentially a problem for the Com-

mission. There is material evidence to support its conclusion of lack of value and its conclusion has been accepted by the District Court. This is sufficient.

In the preceding section of this opinion, we discussed the validity of the provision of subsection (e) which permits the elimination from the reorganization of claimants without equity in the debtor's properties. This provision needs also to be considered from the standpoint of statutory review of the Commission's action. As to both stockholders and creditors the section requires that a plan which allows nothing to their claims need not be submitted to them, if the worthlessness of their claims is found by the Commission, "and the judge shall have affirmed the finding." As to certain creditors and all stockholders in this case, both events took place. The specificity of the direction for reexamination of the Commission's action points to a wider scope of review than an inquiry as to whether statutory standards for valuation have been followed. It is obvious that the valuation of the whole of a debtor's property, in a simple case without conflicting or divisional liens, will mark, by a mere mathematical computation as to priorities, the claimants who must be found to be without equity in whole or in part. But we think the requirement of affirmation of the exclusion of claimants does not require an independent appraisal of the valuation which ordained their elimination. The court properly affirms the Commission, when it finds no legal objection to the Commission's use of its own valuation to determine whether particular claimants are entitled to participate in the reorganization. For example, there may arise controversies over the priority or the validity of claims. A Commission finding involving such problems would require an independent examination and an affirmation by the court.

The Circuit Court of Appeals found error in the Commission's failure to make definite valuations. It was of the view that it was necessary to determine the values of the respective claims in order to have a basis for the distribution of new assets.[26] This position respondents defend, at least to the point of saying that claims may not be foreclosed or new securities allocated without

[26] In re Western Pac. R. Co., 124 F. 2d 136, 139: "To determine this question, it was necessary to determine, as of the effective date of the plan, the value of (1) each of the claims of Reconstruction Finance Corporation, (2) the claim of Railroad Credit Corporation, (3) the claim of A. C. James Company, (4) the claims of the holders of first mortgage bonds now outstanding, (5) the $10,000,000 of new first mortgage bonds, (6) the $21,219,075

a determination of the value of the property and the assets subject to secured claims, as well as earning power. The Commission considered the debtor's investment in its property, 230 I. C. C. 61, 65, its value for rate making purposes, *id.*, 76, and the record of its earnings, *id.*, 73 *et seq.*, together with its volume of traffic and other pertinent data. It concluded that these factors would justify fixed and contingent charges of no more than two million dollars annually. In addition the Commission's plan provided for five per cent preferred stock and common stock in such amounts that it would require aggregate available annual earnings of a little more than four and a half million dollars to permit payment of a three per cent dividend. Without appraising the effect of income taxation on the remainder of earnings available

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of income bonds, (7) the 318,502.97 shares of new preferred stock and (8) the 319,441 shares of new common stock which the plan provides shall be distributed to said claimants.

"To determine the value of the above-mentioned claims, it was necessary to determine the value of (1) the debtor's entire property, (2) the property subject to the first mortgage now outstanding, (3) the $18,999,500 of refunding bonds pledged to secure the claims of A. C. James Company, Railroad Credit Corporation and Reconstruction Finance Corporation and (4) the other collateral pledged to secure each of said claims. To determine the value of the refunding bonds, it was necessary to determine the value of (1) the property subject to the refunding mortgage only and (2) the property subject both to the refunding mortgage and to the first mortgage now outstanding. This, of course, necessitated a determination as to which of the debtor's property is, and which is not, subject to each mortgage. Consolidated Rock Products Co. v. Du Bois, *supra*.

"To determine the value of the new first mortgage bonds, income bonds, new preferred stock and new common stock mentioned above, it was necessary to determine the value of (1) the debtor's entire property, (2) the property which would be subject to the new first mortgage and (3) the property which would be subject to the income mortgage.

"Subsection e of § 77 provides: 'If it shall be necessary to determine the value of any property for any purpose under this section, the [Interstate Commerce] Commission shall determine such value and certify the same to the court in its report on the plan.' In this case, as has been seen, it was necessary to determine the value of (1) the debtor's entire property, (2) each of the claims of Reconstruction Finance Corporation, (3) the claim of Railroad Credit Corporation, (4) the claim of A. C. James Company, (5) the claims of the holders of first mortgage bonds now outstanding, (6) the $10,000,000 of new first mortgage bonds, (7) the $21,219,075 of income bonds, (8) the 318,502.97 shares of new preferred stock, (9) the 319,441 shares of new common stock, (10) the property subject to the first mortgage now outstanding, (11) the $18,999,500 of refunding bonds pledged to secure the claims of Reconstruction Finance Corporation, Railroad Credit Corporation and A. C. James Company, (12) the other collateral pledged to secure each of said claims, (13) the property subject to the refunding mortgage only, (14) the property subject both to the refunding mortgage and to the first mortgage now outstanding, (15) the property which would be subject to the new first mortgage and (16) the property which would be subject to the income mortgage. It thus became the duty of the Commission to determine these values and certify them to the court. That duty was not performed."

and partly used for interest, it is significant that only three years in the period from 1922 to 1940 showed earnings available for interest of over four million. See page 5 *supra*. With this data, the Commission determined the new capital structure. See page 8, *supra*. Taking the lowest value for the no par suggested by the Commission, $57 per share, note 6 *supra*, there is a total value of securities of eighty-four million dollars plus. The Commission was thus of the view that the value of the property for purposes of reorganization was around this figure.

The Commission was familiar with railroad securities. Control over their issue by interstate carriers has been for many years in the Commission. Sec. 20(a), Interstate Commerce Act. The standards for issuance under section 20(a) include "compatible with the public interest." Cf. *N. Y. Central Securities Co.* v. *United States*, 287 U. S. 12, 24. The provisions of this section 20(a) were carried into and made a part of the reorganization section by subsections (c)(3) and (f). To create securities with voting power, in addition to those authorized might well divorce control from real ownership. Sound railroad reorganization involves more than the partitioning of assets among creditors with valuable claims and the distribution to creditors and stockholders without equity of so-called securities representing chances for then unforeseeable profits. The interest of the public in an adequate transportation service must receive consideration. *New England Divisions Case*, 261 U. S. 184, 189. Important property rights must be balanced against the need of sound financing. Consequently, the Commission limited the fixed and contingent charges involving the debt which must ultimately be paid, to two million annually, with stock representing the possibility of additional earnings. See note 5 *supra*, 230 I. C. C. 61, 92.

It is said that *Consolidated Rock Co.* v. *Du Bois*, 312 U. S. 510, forbids the substitution of an approved capital structure for determinations of value. In that case there was no finding of the values of the property involved and this Court said: "Absent the requisite valuation data, the court was in no position to exercise the 'informed, independent judgment' (*National Surety Co.* v. *Coriell*, 289 U. S. 426, 436) which appraisal of the fairness of a plan of reorganization entails," page 520. The district court, it being a section 77B reorganization, was required to make the requisite valuations. The requirements for valuation are the same in a section 77B proceeding as in a railroad reorganization. There is nothing, however, in the *Du Bois* case to

indicate that dollar valuations of the property or claims are essential for recapitalization or the distributions of securities in reorganizations. The defect in *Du Bois* was not the failure to find dollar values but the failure to find the worth of the security behind independent mortgages on distinct properties and of assets subject to the claims of particular groups of creditors. Such findings were required in that case because the court was dealing with a parent and two subsidiaries with inter-company accounts. Each subsidiary entity had its own creditors. The system was a unified operation and we held the claims against the subsidiaries had priority over stockholders equity in the parent, p. 523. Without a separate valuation of assets, it was impossible to tell what assets of the parent were left to form the basis for the securities distributed to the parent's stockholders. In *Du Bois*, as here, the manner of reaching that valuation, so long as it complies with the statutory standards, is not important. There are subsidiaries here but there are no claimants of the subsidiaries looking to the parent. The aggregate of the authorized securities in the present case is to be equitably distributed among claimants against a single corporation. Findings were made as to the property covered by the different mortgages of the debtor and securities allocated on the basis of that finding. 230 I. C. C. 61, 98, 99, 100, 101; 233 I. C. C. 409, 414. Under such circumstances the lack of a valuation in dollars is immaterial. The important element is the allocation of the securities so as to preserve to creditors the advantages of their respective priorities. That is to say, senior claims first receive securities of a worth sufficient to cover their face and interest before junior claims receive anything. Consequently, we are of the opinion that the determination by the Commission of the aggregate amount of securities which may be issued against the system is in substance a finding of total value for reorganization purposes. In view of the factors of value considered and the opportunity given all parties before the Commission and the court to present all desired evidence, the Commission's determination stands upon a firm basis. There is no more important element in the valuation of commercial properties than earnings.[27] No offer was made to produce figures upon reproduction cost. It was not incumbent upon the Commission to do so. The Commission's conclusions impress us as in accord with the statutory requirements.

[27] Cf. Consolidated Rock Co. *v.* Du Bois, 312 U. S. 510, 525.

Allocation of Securities. There are two issues collateral to the Commission's valuation. One relates to adverse claims of prior liens between the holders of bonds secured on the one hand by the General and Refunding Mortgage and on the other by the First Mortgage. See p. 28, *infra*. The other is as to the correctness of the allocation of securities among the creditors. This latter issue is, of course, affected by the former. In considering allocation, we shall assume at this point what we later find, that the Commission's determination as to priorities is correct.

A. The allocation of securities is shown above at page 8. The table sets out that the holders of the Trustees' Certificates and the 5% First Mortgages, although they are senior creditors, receive large quantities of preferred and common stock, as well as new income bonds. These stocks are securities of lower dignity than the income bonds. Some of these bonds on the other hand go to creditors secured by the refunding bonds. This is because the refunding bonds have a first lien on some assets. 233 I. C. C. 414. But at any rate, under the absolute priority rule of the *Boyd* case,[28] the stratification of securities issued to creditors need not follow invariably the relative priority of the claimants.[29] Apropos of a somewhat similar situation, we said in *Consolidated Rock Co.* v. *Du Bois*, 312 U. S. at p. 530:

"If the creditors are adequately compensated for the loss of their prior claims, it is not material out of what assets they are paid. So long as they receive full compensatory treatment and so long as each group shares in the securities of the whole enterprise on an equitable basis, the requirements of 'fair and equitable' are satisfied."

B. A point is made as to the treatment of the Reconstruction Finance Corporation's claims in the distribution of securities. It is to be noted, page 3 *supra*, that R. F. C. has two kinds of claims; one for $10,000,000 upon Trustees' Certificates for money advanced to the debtor while in reorganization, the other for $2,963,000 Collateral Notes, secured by refunding mortgage bonds. The Railroad Credit Corporation and the A. C. James Company are holders of similar collateral notes. The amount of bonds, as compared with the face principal of the indebtedness, varies. The R. F. C. has the most valuable collateral per dollar of in-

[28] Northern Pacific Ry. *v.* Boyd, 228 U. S. 482.

[29] Group of Institutional Investors *v.* C. M., St. P. & P. R. R. Co., Nos. 11-19, 32, 1942 Term, decided this day, slip opinion, pp. 27-29.

debtedness. To retire the Trustees' Certificates and to raise necessary new money for the reorganization, the Commission deemed it essential to sell $10,000,000 of new first mortgage, 4% bonds of 1974. To assure this, the Commission provided:

"That the [R. F. C.] purchase the bonds at par and accrued interest and that, in consideration of such purchase and the value of the collateral securing its claim, the Finance Corporation receive, for the secured notes of the debtor held by it, treatment equal to that accorded holders of the debtor's existing first-mortgage bonds."

Respondents' objections to this ruling are that the Commission acted without a finding of the value of the new bonds or their marketability at par, that the advancement of the R. F. C. secured claim to priority over the like claims of other holders violates absolute priority and that there is no finding of reasonable equivalence between the preference and the value of R. F. C.'s taking the bonds. It is further urged that securities distributed to the R. F. C. to refinance the Trustees Certificates "should be in recognition of the priority inherent in that transaction" and not in connection with the loan of R. F. C. to the debtor, which was made prior to reorganization proceedings.

It is admitted that the $10,000,000 Trustees Certificates or such of them as are presently held by the R. F. C. are worth par. No finding was made by the Commission of the value of the new Firsts. Evidence before the court showed them of a value between 80 and 90 and of poor marketability on account of the system's interest record. The court made no finding as to either.

If the R. F. C. were treated on its notes, on the basis of the proportion of bonds held as collateral, precisely as the other noteholders, it would receive $414,175 of income mortgage bonds and $649,516 of new preferred stock, in addition to its proportion of common stock. 233 I. C. C. 409, 416. This proportion of common stock would allot a much greater aggregate of common stock to the R. F. C. than it obtained by the adjustment. By reason of accepting the less valuable new Firsts in lieu of cash for its $10,000,000 Trustees' Certificates, it will receive for the principal of its claims $1,185,200 of new income bonds and $1,777,800 of new preferred stock. The R. F. C. received its unpaid interest in no par common stock at $57 per share. This is the same allocation given claimants who hold the old Firsts. 233 I. C. C. 409, 452. The other note holders received a large proportion of the principal of their claims in no par common stock at $62 per share.

It is difficult to appraise in dollars, as of the date of the Commission approval, the advantage secured for the plan by the arrangement with R. F. C.. It is equally difficult to appraise similarly as of that date the value of the Trustees' Certificates relinquished by the R. F. C. over the value of the new Firsts or to determine how much of additional worth the R. F. C. obtained. The argument that the Commission does not have statutory authority to pay a creditor, even R. F. C., a government banking corporation, for furnishing new money has little weight. Nor do we see any reason why all claims of R. F. C. may not be considered by the Commission as a single claim. *Consolidated Rock Co.* v. *Du Bois*, 312 U. S. 510, 529. There is nothing to lead us to a conclusion that the Commission gave any advantage to R. F. C. for which full consideration was not given. New money, the Commission said, "is absolutely necessary to effect a reorganization." 233 I. C. C. 409, 414. We have no reason to think the Commission allowed more compensation for this new money to R. F. C. than it would have been compelled to allow in some way, by interest or additional collateral or otherwise to another supplier. We conclude there was nothing in the discretionary action of the Commission to justify its invalidation.

C. We have held hereinbefore that valuation might be made by a method based primarily upon earnings and that so long as creditors receive "full compensatory treatment" their priorities may be represented by securities of different ranks. The Commission has made allocations of securities to the various creditors according to its judgment of the worth of their creditor position or priority in relation to the total worth of the property. It has found specifically that certain claims, under its valuations, have no value. We have pointed out the evidence before the Commission on the question of value. We cannot see that putting definitive dollar values on the whole and on parts of this property would aid the Commission in its work of valuation or the courts in their limited review of the Commission's action.

By its order of June 21, 1939, section P, 233 I. C. C. 441, 451, confirmed September 19, 1939, 236 I. C. C. 1, the Commission authorized the issue of around eighty-four million dollars of securities against the system property. This treats the equipment trusts and the securities with a face value as worth par and the no par common stock at $57 per share for all recognized creditors except the Railroad Credit Corporation and the A. C. James

Company. For distribution to these latter two creditors, the common was valued at $62.

The Commission had before it the data pertaining to past traffic, receipts, earnings and operating ratios, the system's physical condition and prospects for business. This gave an adequate basis for an intelligent estimate of future income likely to be available to meet annual charges before dividends and those dividends themselves.

From this information, a conclusion was reached as to the debts which could be paid in the order of their full or absolute priority. *Case v. Los Angeles Lumber Co.*, 308 U. S. 106, 117. The secured claim of A. C. James Company could not be satisfied in full even with the more liberal valuation of the common stock. Claims of lesser dignity were eliminated. Those entitled to priority over the mortgages, that is, current liabilities, trustees obligations and reorganization expenses, were to be satisfied by cash or assumed by the reorganized company as a charge on its assets superior to the new securities. 233 I. C. C. 409, 452; 230 I. C. C. 61, 100, 101, 102. This left as creditors only the holders of the old 5% Firsts, with an underlying mortgage on the greater part of the property, the R. F. C., the Railroad Credit Corporation and the A. C. James Company, the latter three with refunding mortgage bonds as collateral. We have already explained the arrangement whereby R. F. C. acquired the status of a first mortgage bondholder. Here it is sufficient to say that as determined by the Commission the Refundings had a lien superior to the Firsts on some assets, (233 I. C. C. 414) and the First superiority over the Refunding on the major portion. 230 I. C. C. 61, 97. See *infra*, *Priorities of Conflicting Liens*. With the foregoing facts and primary findings before it, the Commission drew the final conclusion as to allocation of securities as set out on page 8 *supra*. This allocation was based upon "the relative priority, value and equity of the various claims." Cf. 233 I. C. C. 414, 416, 417, 451 P. The distribution and report seems in accord with the requirements and standards of subsections (b), (d) and (e)(1), note 7 *supra*.

Priorities of Conflicting Liens. No. 61 is a petition by the Irving Trust Company, trustee of the General and Refunding Mortgage, which raises questions of the priority between the Refunding Mortgage and the First Mortgage as a lien on three classes of property. These are the debtor's equity in certain rolling stock and equipment acquired under equipment trusts

and a lease, the debtor's interest in the Northern California Extension and the debtor's title to certain "non-carrier" property. The Commission's plan is predicated on the priority of the First Mortgage as a lien on these properties and the Commission accordingly undertook tentatively to determine the legal questions involved. The Commission held that the First Mortgage, senior to the Refunding Mortgage, should be considered to be a first lien on these three classes of property. Petitioner, the Irving Trust Company, as substituted trustee under the Refunding Mortgage, made appropriate objections but the ruling of the Commission was adopted by the District Court. In reversing on appeal, the Circuit Court of Appeal did not pass on the question though the issue was presented. The point is made here by a party prevailing below, the petitioner Irving Trust Company on behalf of holders of refunding mortgage bonds. As the matter is fully presented by the petition for certiorari and its decision is essential to a complete review of the District Court we have concluded to consider the question. Section 240(a) Judicial Code, 28 U. S. C. § 347. *United States* v. *Bankers Trust Co.*, 294 U. S. 240, 294, 295. Such action is in the interest of expedition. *Continental Bank* v. *Rock Island Ry.*, 294 U. S. 648, 685. Cf. *Story Parchment Co.* v. *Paterson Co.*, 282 U. S. 555, 567; *Cole* v. *Ralph*, 252 U. S. 286, 290.

The issues are those of construction of the terms of the First Mortgage. In the case of the first two classes of property, which were acquired after 1916, the year of the mortgage, the question is whether such property is covered by the after acquired property clauses of that indenture and in the case of the third class, the "non-carrier" real property, the question is the application of the granting clauses to property not intimately connected with the operation of the road at the time of the 1916 reorganization of the debtor. None of the parties relies, at least as to personalty, on the controlling nature of rules of law of a particular jurisdiction. The Commission treated the question as one of the interpretation of the language of the mortgage and we shall do likewise.

A. As to the first class of property, it is the contention of the trustee of the Refunding Mortgage that the debtor's equity in the rolling stock subject to the three equipment trusts and the lease is not subject to the lien of the First Mortgage and that it is subject to the lien of the Refunding Mortgage. Since nothing turns on the difference between the equipment trusts and the

lease, they will not further be distinguished. This equity is stipulated to have been worth over $6,000,000 on December 31, 1935, the nearest date available to August 21, 1935, the date of the filing of the petition. Since the obligations secured by all the refunding mortgage bonds outstanding amount to eleven millions it is apparent that determination of this question in favor of the refunding mortgage bondholders would go far towards assuring them equality of treatment with first mortgage bondholders.

The equipment trusts, the usual method of financing the acquisition of rolling stock, were created in 1923, 1924, 1929 and 1931. All are dated between the execution of the First Mortgage and the Refunding Mortgage. Under all, as is usual, the trustee retained title to the equipment, the debtor's equity in the property increasing as it satisfied the serially maturing obligations. The obligations of two of the trusts have become fully satisfied since the institution of this proceeding.

The first of the granting clauses of the First Mortgage conveys presently owned railroad lines, equipment and other property formerly the property of the debtor's predecessor and specifically enumerating, under the subheading "equipment", several varieties of cars and "other rolling stock." Granting clause third, entitled "after-acquired property," covers

"Any and all property and facilities of any and every kind and description, including . . . equipment . . . and any and all right, title and interest in any of such properties or facilities which may from time to time hereafter be acquired or constructed by or belong to" the debtor, if such property falls into any one of four categories:

(1) Property acquired "by the use of First Mortgage Bonds or proceeds thereof or cash deposited" under the first mortgage "or on account of the purchase, acquisition or construction thereof or work thereon" such bonds or sums are paid out; or

(2) Property constituting "an integral part or parts of lines of railroad, extensions, branches, or other property subject to the lien" of the first mortgage; or

(3) Property "used or acquired for use in or for the maintenance or operation of or appertaining to" any of the property subject to the lien of the first mortgage; or

(4) Property consisting of securities of or other interest in the property of the Salt Lake City Union Depot & Railroad Company or Standard Realty and Development Company, or any subsidiary as defined.

The fifth granting clause covers a great variety of properties and facilities used in the operation of a railroad, including tracks,

bridges, tunnels, telegraph and telephone lines, floating equipment and specifically several kinds of cars "and other rolling stock and equipment" and "all other property of every description and all rights and interests in or with respect to the use of property;

"provided that the foregoing or any thereof, whether now owned by the Company or at any time hereafter acquired by it . . . . shall be appurtenant to or used or held for use as, or as a part or as parts of, or to facilitate or safeguard the maintenance or operation of, any lines of railroad, extensions, branches . . . or other properties now or at any time hereafter subject to the lien of this indenture. . . ."[30]

Following the habendum clause is a proviso, hereafter referred to by its two opening words, reading:

"Subject, However, as to all equipment now owned to the equipment trust or conditional sale agreements secured thereon, and as to equipment hereafter acquired, to the equipment trust or conditional sale agreements to which the same shall be subject as permitted hereby, . . ."

It is stipulated that all the equipment subject to the equipment trusts in question was acquired for use and was used on all of the debtor's lines, including those specifically described in the granting clauses. This would seem to make clear that the debtor's equity in equipment trust rolling stock is covered by the lien of the First Mortgage. Subdivision (3) of the third, after acquired property clause, as well as the fifth granting clause, apply.

The refunding mortgage trustee relies, however, on a clause found between the sixth granting clause and the habendum, hereafter referred to as the reservation clause, and reading:[31]

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[30] This clause also grants "any and all replacements, renewals, improvements and betterments of and additions to" any of the lines or property subject to the lien of the mortgage. In view of the holding as to effect of those clauses quoted in the text it will be unnecessary to consider the contention of the trustee of the First Mortgage that this clause, as supplemented by certain covenants, independently subjects the debtor's equity in equipment trust rolling stock to the lien of the mortgage.

There are six granting clauses. The second covers all lines, lands, structures and equipment and other property, interests or rights, legal or equitable, then owned by the Company, and not set forth particularly. The fourth provides for the grant of additional security, and the sixth covers legal and equitable rights, claims and demands, and rents and income in the property subject to the lien of the indenture.

[31] The portion of this clause preceding that quoted in the text provides:

"But nothing express or implied in this indenture shall be construed to limit the right or power of the Company or any successor or purchasing corporation, which right and power is hereby expressly reserved, by the use of its credit or free funds or by the use of First Mortgage Bonds delivered to

"and the Company may, unless First Mortgage Bonds shall have been authenticated and delivered or their proceeds or other cash deposited hereunder paid out against the same, purchase and acquire equipment, free from the lien hereof, by lease, conditional sale agreement or under any form of equipment trust, or purchase such equipment and issue obligations therefor secured by mortgage or pledge of such equipment superior to the lien of this indenture."

It is argued that this reservation permits the acquisition of rolling stock entirely free from the lien of the First Mortgage, unless acquired, as was not the case here, by the use of proceeds of the first mortgage bonds.[32]

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the Company or any successor or purchasing corporation as in this indenture provided to reimburse the Company or any such successor or purchasing corporation for expenditures theretofore actually made out of its free funds, to construct or acquire free from the lien hereof lines of railroad, extensions or branches or interests therein, equipment, stocks, bonds or other securities or other property, rights, franchises, immunities or privileges provided the same shall not be lines of railroad, extensions, or branches or interests therein, equipment, stocks, bonds or other securities, or other property, rights, franchises, immunities or privileges (a) on account of the purchase, acquisition or construction whereof or work whereon First Mortgage Bonds shall be authenticated and delivered or their proceeds or other cash deposited hereunder shall be paid out as herein provided; or (b) consisting of, or if securities representing, property or facilities constituting an integral part or parts of lines of railroad, extensions, branches or other property subject to the lien of this indenture or some other integral portion whereof is or integral portions whereof are subject to the lien hereof or represented by securities subject to the lien hereof; or (c) consisting of or, if securities, representing property or facilities used or acquired for use in or for the maintenance or operation of or appertaining to any of the lines of railroad, extensions, branches or other property subject, or represented by securities subject, to the lien of this indenture; or (d) consisting of shares of stock in or other securities of said The Salt Lake City Union Depot and Railroad Company or said Standard Realty and Development Company or any subsidiary company or of any right, title or interest which the Company or any successor or purchasing corporation may acquire in or to any of the property of either of the companies above named or in or to any line of railroad or other property of any corporation which shall then be or immediately prior thereto shall have been a subsidiary company as the term subsidiary company is defined in Section 2 of Article Second hereof;"

[32] The trustee finds further support for this argument in a comparison of the four limitations on the acquisition of property from free funds found in the opening portion of the reservation clause, quoted in the preceding footnote, with the latter portion of the clause, quoted in the text. The opening portion contains four limitations, of which only two are relevant to this argument. The first of these four limitations is that the property may not be acquired by the use of first mortgage bonds or their proceeds and the third relates to property acquired for use in the operation of the road which is subject to the mortgage. It is only this first limitation which is repeated in the latter portion of the reservation clause. It is argued that the omission to repeat the limitation as to property acquired for use in the operation of the road shows an intention that such a limitation should not apply in that latter portion. From this it is said to follow that property acquired for use in the operation of the road but not bought with first mortgage moneys is not subject to the mort-

We do not so view the reservation. It rather performs the function of authorizing the acquisition of equipment by equipment trust or other method and only to that extent displacing the lien of the First Mortgage arising from the after acquired property clauses. The granting clauses show a purpose to subject to the First Mortgage all the property and equipment used in connection with the road. There is repeated general mention of the grant of rolling stock, of legal and equitable interests. The third and fifth granting clauses fully cover this after acquired equity in rolling stock purchased through equipment trusts and the "Subject, however" clause clearly contemplates that the First Mortgage shall be a lien on equipment second only to equipment trust agreements. That clause provides for the subordination of the First Mortgage to equipment trust agreements to which after-acquired equipment shall be subject "as permitted hereby." These last words, a reference to the reservation clause, confirm our view that the function of the reservation clause is merely to permit the purchase of equipment by that method and not to authorize the completely untrammeled acquisition of such equipment.

It is urged that the words "free from the lien hereof" in the reservation clause must be given their literal significance. The

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gage, i. e., that the words "the Company may . . . purchase . . . equipment, free from the lien hereof, by lease, conditional sale agreement or under any form of equipment trust" should be read literally without regard to the purpose of the clause taken together with the remainder of the mortgage. Thus all but the conclusion of this argument is merely a variation of the argument discussed and rejected in the text, that the words "free from the lien hereof" are to be taken literally and that the purpose of the latter portion of the reservation clause was to accomplish the result contended for by the refunding mortgage Trustee.

If it be said that the words "free from the lien hereof" in the opening portion of the reservation clause have a different meaning from that which we give those same words in the latter portion of the clause the answer must be that in view of the different functions of the two portions of the reservation clause, the difference is required. The opening portion is entirely consistent with granting clause third and the remainder of the reservation clause.

The four limitations in the opening portion of the reservation clause substantially correspond to the four categories of after acquired property which are subject to the mortgage under granting clause third. By the third granting clause, after acquired property in these four categories is subject to the mortgage. By the opening portion of the reservation clause, property not in these categories may be purchased with free funds and will be free from the mortgage. This is so because the categories, as defined in both places, do not comprehend property unconnected with the road of the debtor. Thus the purchase with free funds of a foreign railroad or of domestic real estate unconnected with the road would be permissible under the opening portion of the reservation clause, would not have been covered by the third or fifth granting clauses and might conceivably be the subject of a supplemental indenture under granting clause sixth. See p. 30, *supra*.

argument must fail aside from the difficulties inherent in a suggestion that these words shall be lifted from context and forcibly applied without reference to an intention fairly to be drawn from three specific clauses of the mortgage and reinforced by the entire scheme of the document. The reservation clause provides that the company may acquire equipment "free from the lien hereof" if the method be by lease, conditional sale or equipment trust but may "purchase such equipment and issue obligations therefor secured by mortgage or pledge of such equipment superior to the lien of this indenture." Why the difference? Equipment acquired for cash would unquestionably become subject to the First Mortgage. Equipment acquired under a purchase money chattel mortgage would under this clause be subject to the mortgage. The First Mortgage would merely be junior to the chattel mortgage. Yet equipment acquired under an equipment trust agreement is said to be entirely free of the mortgage. The inconsistency[33] of such a result suggests that the phrases "free from the lien hereof" and "superior to the lien of this indenture" are in a sense correlative and were merely suited to the different title situations in the two methods of financing.

B. The Northern California Extension is a 112 mile branch of the debtor's main line and runs from Keddie, California, to the Great Northern Railroad at Bieber, California. It has been profitable since its construction in 1932 and the Commission expects that its traffic will increase. As has been stated the question as to the extension is whether it is covered by the after acquired property clauses of the First Mortgage. Slightly less than one-half the cost of the extension, or about $5,000,000, was financed by the sale of first mortgage bonds; another $5,000,000 was realized from the sale of unsecured debentures to the A. C. James Co., later replaced by collateral notes secured by refunding mortgage bonds, and the remainder, approximately $500,000, was borrowed from the R. F. C. on the security of refunding mortgage bonds.[34]

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[33] No reason suggests itself as to why equipment acquired for cash should have been intended to be covered by the First Mortgage and equipment acquired by the equipment trust method not be subject to the mortgage after the equipment trust obligation is completely satisfied. Yet this is a consequence of the argument pressed upon us.

[34] Construction of the extension was begun in August, 1930, and by the end of December a substantial amount of the work had been completed. Connection with the Great Northern was made on November 10, 1931, and freight service was then inaugurated under the jurisdiction of the construction department. On June 1, 1932, the line was placed in full operation. The cost of construction to May 31, 1932, was $10,183,641.90 and additional sums were

In view of this the refunding mortgage trustee contends that the First Mortgage should as a matter of equity be held a lien on the extension only to the extent of first mortgage moneys used or that it be held a first lien on a portion of the mileage equal to the proportion that first mortgage moneys bore to the total cost, or on an undivided interest in the extension in the same proportion. But here again the terms of the First Mortgage preclude such a contention. The third granting clause covers "any and all property . . . including . . . extensions . . . if

(a) acquired or constructed by the use of First Mortgage Bonds or proceeds thereof or cash deposited hereunder (except bonds delivered or cash paid out under any of the provisions of this indenture in reimbursement of previous expenditures certified as hereinafter provided) or on account of the purchase, acquisition or construction thereof or work thereon First Mortgage Bonds shall hereafter be authenticated and delivered or the proceeds of First Mortgage Bonds or other cash deposited hereunder shall hereafter be paid out under any of the provisions of this indenture; . . ."

The reservation clause supplements this by its provision that the right to acquire property free of the lien shall not extend to "lines of railroad, extensions or branches . . . (a) on account of the purchase, acquisition or construction whereof or work whereon First Mortgage Bonds shall be authenticated and delivered or their proceeds or other cash deposited hereunder shall be paid out as herein provided; . . ." See n. 31, *supra*.

The substantial nature of the financing of the extension by the sale of first mortgage bonds is a matter of record and we hold that the quoted portion of the third granting clause and especially the clause beginning "or on account of the purchase, acquisition or construction thereof or work thereon" bring this extension within the coverage of the First Mortgage. In opposition to this conclusion it is said that it would permit the First Mortgage to

later expended. It was financed as follows: First mortgage bonds in the amount of $5,000,000 were sold at 97½ between February 11, 1931, and January 29, 1932, producing $4,875,000. Between February 27, 1931, and May 31, 1932, $5,000,000 of debentures, issued under an indenture dated July 1, 1930, were sold for cash at par to A. C. James Co. These debentures were retired in March and May, 1932, through the issue of notes to the A. C. James Co. for $4,999,800 ($200 being paid in cash) secured by a pledge of $6,249,500 face amount of refunding mortgage bonds. The Refunding Mortgage was executed and delivered February 29, 1932, as of January 1 of that year. The remainder of the total cost of construction was financed by loans of $559,408 procured from the R. F. C. in March, June and August, 1932. These were parts of larger loans and were secured by refunding mortgage bonds.

become a lien on the extension if only one penny of first mortgage money had been used. That is of course not our case. Here we have a considered plan for financing an extension which contemplated that 50% of the necessary moneys be procured through the sale of first mortgage bonds. The terms of the after acquired property clause disclose an intention that where at least such part of the funds used for the construction of such an extension are first mortgage funds that the entire extension should be subjected to the lien of the mortgage. The refunding mortgage trustee contends that it is inequitable to give the first mortgage bondholders a lien to the extent of all first mortgage bonds outstanding when in fact those bondholders contributed only $5,000,000 to the cost of construction and the refunding mortgage bondholders contributed the remainder. The asserted inequity disappears on a reference to the record where it plainly appears that the parties concerned had no understanding that the lien situation would be different from what we have held it to be.[35]

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[35] The primary parties conecrned were The Western Pacific Railroad Corporation, purchaser of the $5,00.,,00 of first mortgage bonds in question and the A. C. James Co., purchaser of a like amount of debentures. The A. C. James Co. in 1929 offered to finance the cost of the extension in return for a first lien thereon. It was then believed that the cost of the extension would be approximately $5,000,000. When it developed that it would greatly exceed that amount, the A. C. James Co. withdrew this offer and substituted another offer to advance 50% of the moneys needed, the advances not to exceed $5,000,000. No mention was made in this second offer of a first lien or, indeed, of any lien and the indenture under which the debentures were issued was equally silent. The parties were fully aware that the remaining 50% of the cost would be paid by the sale of first mortgage bonds or other funds. The second offer, in the form of a commitment to bid at public sale, was accepted by the debtor.

The specifications referred to in the notice calling for bids on the debentures contain the following:

> "The main line of railroad of the Company extends from San Francisco, California, to Salt Lake City, Utah, with branches, and aggregates 1050.5 miles more or less of first track. Upon the completion of the Company's 'Northern California Extension' its main line of railroad will aggregate 1198.5 miles, more or less. A map of the Company's railroad system is hereto annexed.
>
> "The First Mortgage of this Company dated June 26, 1916, securing this Company's First Mortgage Bonds, whereunder not more than $50,000,000. thereof may be outstanding at any one time, is a first lien on said main line of railroad."

The bid of the A. C. James Co. stated that it was made in accordance with the specifications, which had been examined by the bidder.

The specifications in connection with the offers of the $5,000,000 of first mortgage bonds contain similar statements:

> "Said First Mortgage constitutes a first lien on the main line of railroad of the Company extending from San Francisco, California, to Salt Lake City, Utah, and branches, aggregating 1050.5 miles, more or less, of first track, the Company's terminal and other railroad properties in the cities

C. Lastly, the refunding mortgage trustee makes a limited claim against certain "non-carrier" realty which is alleged to be completely free of the lien of the First Mortgage. The refunding mortgage trustee believes that this property should be given consideration as unmortgaged property in the allocation of securities to the refunding mortgage creditors.

The greater part of this property, which was not used for railway purposes, was acquired from the debtor's predecessor, the Western Pacific Railway Company, pursuant to its reorganization in 1916 and the question is whether this property is within the terms of the First Mortgage.[36] We answer this question affirmatively. Despite the fact that it is or was not used for transportation purposes, the mortgage nevertheless covers it by the conveyance of:

"First.—All and singular the following described lines of railroad, terminals, lands, equipment, shares of stock and other real and personal property and interests and rights in property owned by the Company or to which it may be entitled, formerly the property of or belonging to Western Pacific Railway Company, a corporation of the State of California, or its receivers: . . ."

. . . . . .

"III. All terminals and all lands and interests in lands, easements therein and improvements thereon, including, among other things, yards, station and depot grounds, sheds, station houses,

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of San Francisco, Oakland and elsewhere, and certain of its rolling stock and equipment. Upon the completion of the construction and/or acquisition of the Company's 'Northern California Extension' its main line of railroad will aggregate 1198.5 miles, more or less. A map of the Company's railroad system is hereto annexed.'

The bids of The Western Pacific Railroad Corporation contain a reference to the specifications similar to that in the bid of the A. C. James Co.

Mr. A. C. James was during this time the president and a director of the A. C. James Co., a director of the Western Pacific Railroad Corporation and a director of the debtor.

It is not suggested that the understanding of the Reconstruction Finance Corporation as to the lien of the refunding mortgage bonds pledged with it to secure the loans made to complete payment for the extension was different. See Western Pac. R. Co. Reconstruction Loan, 180 I. C. C. 645, 646, 648-9, an exhibit herein.

[36] A portion of this "non-carrier" property was acquired after 1916, some of it by the use of first mortgage moneys and some of it in substitution for property released from the lien of the First Mortgage. The refunding mortgage trustee makes no claim to the property acquired by the use of first mortgage moneys. Another small portion of the property was acquired after 1916 but without the use of first mortgage moneys, for use as future industrial sites and for gravel pit purposes. The claim to this last property is not specified in the briefs of the refunding mortgage trustee and it seems to be of such negligible value as would not warrant a reallocation of securities if it were to be held that this property is not subject to the first mortgage lien.

freight houses, warehouses, elevators, stock-yards, car-houses, engine houses, oil tanks, water tanks, water supply, shops, hotels, boarding houses, hospitals, docks, wharves, piers, slips, telephone and telegraph lines and other structures and erections and the appurtenances of all and every of the foregoing, whether or not for use in connection with said or any lines of railroad."

The last subdivision of the first granting clause, which follows six subdivisions specifically describing certain properties, conveys:

"other property.

VII.—All and singular the property, interests and rights, (except cash, accounts and bills receivable, traffic and other operating balances and other cash items) not comprised in the descriptions contained in the foregoing subdivisions of this clause First of these granting clauses, which belong to the Company or to which it may be entitled in any manner and which heretofore were owned by Western Pacific Railway Company or to which said company was or its receivers were entitled."

Reinforcing these provisions is the second granting clause:

"Second.—All other lines of railroad, extensions, branches, terminals, lands, structures, equipment, shares of stock, bonds, notes and other securities, claims, franchises, privileges and immunities and other property and estates, interests and rights (whether legal or equitable) now owned by or belonging to the Company, notwithstanding the same or any thereof may not be particularly set forth in these granting clauses."

In these clauses it is repeatedly specified that all property, railroad or otherwise, formerly owned by the debtor's predecessor and to which the debtor succeeded, is to be subject to the First Mortgage.

We therefore affirm the District Court's conclusion adopting the Commission's tentative determinations as to the priority of the First Mortgage.

Accommodation Collateral. The debtor, The Western Pacific Railroad Company, objects to the provision of subdivision R of the Commission's final order, approved by the District Court, directing that

"All collateral pledged by the debtor as security for notes to the Reconstruction Finance Corporation, the Railroad Credit Corporation, and the A. C. James Company shall be reduced to possession by the respective pledgees thereof, and shall be by them surrendered to the reorganized company and canceled. . . ." 233 I. C. C. 453; 34 F. Supp. 493, 505.

This order arises from the following circumstances. As is shown on page 3, *infra*, the Reconstruction Finance Corporation, the Railroad Credit Corporation and A. C. James Company have notes of the debtor secured by pledges by the debtor of various amounts of the debtor's General and Refunding Bonds and other collateral.[37]

To assist the debtor in obtaining the Reconstruction Finance Corporation and Railroad Credit Corporation loans, the A. C. James Company furnished to the debtor a block of refunding bonds, previously issued to A. C. James Company by the debtor and Western Pacific Corporation furnished to the debtor other collateral described in the Commission finding. These securities were a part of those then pledged by the debtor to secure the notes held by Railroad Credit Corporation and Reconstruction Finance Corporation, which knew the source of the collateral at the time.

The debtor's objection to the Commission's order is stated by it as follows:

"In substance, the Commission provided that the collateral owned and pledged by the Debtor should be surrendered to the reorganized Company but that the accommodation collateral borrowed from others and pledged by the Debtor should be confiscated; or, to state the proposal somewhat differently, the accommodation collateral is to be resorted to first instead of last as is required by the most elemental principles of equity and by the authorities cited below."

We think, however, that the objection is not sound and that the Commission's order is correct. These are our reasons. The refunding bonds pledged by the debtor to secure the A. C. James

[37] The claims and security therefor were found by the Commission to be, as of June 30, 1938, as follows: "class 3 items consisted of $4,999,800, face amount, of notes to the A. C. James Company, on which accrued and unpaid interest amounted to $1,124,955, and which are secured by $4,249,700, principal amount, of the debtor's general and refunding bonds, and a second lien upon $2,000,000, principal amount, of the same issue of bonds held by the Railroad Credit Corporation; class 4 items consisted of $2,963,000, face amount, of notes to the Reconstruction Finance Corporation, on which accrued and unpaid interest amounted to $649,181, the notes being secured by $10,750,000, principal amount, of the debtor's general and refunding bonds, and voting-trust certificates for half of the voting stock of the Denver & Rio Grande Western Railroad Company, and a second lien upon $2,000,000, principal amount, of the same issue of bonds held by the Railroad Credit Corporation; class 5 items consisted of $2,445,610, face amount, of notes to the Railroad Credit Corporation, on which accrued and unpaid interest amounted to $135,296, which notes are secured by $4,000,000, principal amount, of the debtor's general and refunding bonds, and a second lien upon the security held by the Reconstruction Finance Corporation, an assignment of certain advances by the Western Pacific Railroad Corporation, and an assignment of the distributive share of the debtor under the marshaling and distributing plan, 1931;" 230 I. C. C. 77.

Company note and left in that position throughout were pledged directly by the debtor and are not accommodation collateral in any sense. Nor do we need give consideration to the accommodation collateral behind the Reconstruction Finance Corporation and Railroad Credit Corporation notes other than the refunding bonds. In the earlier order approving the plan, the Commission provided that the rights of the Reconstruction Finance Corporation and Railroad Credit Corporation "in collateral pledged with them by parties other than the debtor" should not be disturbed or altered. 230 I. C. C. 102; subdivision O of the order of October 10, 1938, *id.* 114. On consideration of the petitions for modification of this order, the Commission refused to direct that this collateral be "surrendered to the pledgors thereof." 233 I. C. C. 431, 432. In its order, however, promulgating the present plan there is no clause comparable to subdivision O of the previous order preserving the rights of Reconstruction Finance Corporation and Railroad Credit Corporation in the collateral pledged with them by "parties other than the debtor." The sole provision in the final order as to the collateral behind the Reconstruction Finance Corporation and Railroad Credit Corporation is that found in subdivision R and quoted at the opening of this section of this opinion, directing the collateral pledged by the debtor with Reconstruction Finance Corporation, Railroad Credit Corporation and A. C. James Company, be reduced to possession, surrendered to the reorganized company and canceled. This was entirely proper. None of the collateral, other than the refunding bonds, was a claim against the debtor. A. C. James Company and the Western Pacific Corporation perhaps had unsecured claims against the debtor for their securities and other collateral which the debtor had borrowed but these were held worthless as claims against the debtor. 233 I. C. C. 452. This collateral, other than the refunding bonds, was therefore left with the pledgees with its position unaffected by any direct action of the Commission.

The "collateral pledged by the debtor" referred to in the excerpt from subdivision R of the Commission's final order, 233 I. C. C. 453, quoted above, can be only the general and refunding bonds of the debtor, including those previously furnished by A. C. James Company. The words used in subdivision R to describe them are the same used by the Commission in distinguishing the refunding bonds from the remainder of the accommodation col-

lateral. 233 I. C. C. 431, 432. Of course the collateral loaned to the debtor which was not an obligation of the debtor could not be ordered by the plan to be canceled. It remained with the pledgees. This "collateral pledged by the debtor" was properly to be reduced to possession by the pledgees, surrendered and cancelled. For these bonds, furnished by A. C. James Company, held as collateral with other bonds of the debtor, the Reconstruction Finance Corporation and Railroad Credit Corporation received their allotment of new securities, 230 I. C. C. 101, as modified by the Reconstruction Finance Corporation arrangement, described in this opinion at page 25. See 233 I. C. C. 414, 452. The A. C. James Company unsecured claim against the debtor for the loan of the bonds is valueless, 233 I. C. C. 452, and the plan does not deal with any possible claim of accommodation pledgors against pledgees of bonds which were not the property of the debtor.

Change of Conditions. The plan now under consideration was certified to the court on September 28, 1939. To provide for a $3 dividend on the no par stock, the plan calls for future earnings available for betterments, interest, sinking fund and dividends of over $4,500,000. The table on page 5 shows how difficult it had been for the system to earn that amount. Anticipated earnings was the principal factor governing the valuation of the property and the dollar volume of new securities, and past earnings was an important factor in estimating future earnings. A higher estimate of future earnings available for dividends might have created an equity for unsecured creditors or even stockholders. Furthermore, respondents urge that the "earning power" of the property referred to in subsection (e) means not only realized earnings but the system's ability, utilizing its present facilities to the full, to earn increased returns. This we deem of little weight against the history of past operations. Respondents ask us to take into consideration the changed conditions since the Commission acted. There are a few years of actual experience subsequent to the certification. By stipulation of the parties reports of operating results, combined, have been filed for our consideration for the period beginning December 1938 down to and including July 1942. Since we have agreement among the parties as to the earnings available for interest, as adjusted, through 1939, see page 5 *supra*, we need refer only to subsequent periods. These reports show the following sums available for interest, 1940—

$2,513,090; 1941—$4,548,128; 1942 (7 months) $4,830,986,* less relatively minor deductions which have not been consistently treated in the reports. This last group of figures is utilized by us as a rough extension of the table of earnings on page 5. They are useful to show the striking increases over the old averages but have not been adjusted to conform mathematically with the table of earlier years.

In the interest of advancing the solution of as many problems in reorganization as possible we have deliberated upon the effect to be given these unexpectedly large earnings. There are factors in these increased incomes which obviously affect their weight as evidence of continued capacity to produce earnings available for dividends. The effect of taxation is not wholly answered by deductions of tax estimates on the basis of present rates. The reduction by the plan of outstanding interest bearing securities makes income taxes more likely to affect net earnings. Increased wages and costs must be reckoned with and increased maintenance may reasonably be expected from increased use. Already serious proposals for decrease of tariffs have been advanced. Order of the Interstate Commerce Commission in *Ex parte No. 148*, January 4, 1943.

Respondents, of course, admit that the needs of war have increased traffic. Transcontinental transportation has at the moment displaced a large proportion of that from coast to coast, via the Panama Canal. Buses and trucks have yielded much of their gains in volume to railroads. But respondents point to the Northern California Extension and the Dotsero Cutoff as permanent feeders to the debtor's growing business. They see a post-war reconstruction and rehabilitation period which promises a continuance of heavy railway use into the indefinite future. This, say respondents, is to be appraised in the light of the necessity for a national transportation system adequate for the productive capacity of the war facilities, when they are turned to peaceful pursuits.

The Commission, at the time of its certification to the court, September 28, 1939, acted as the results of increased business were just emerging into increased profits.[38] In objections to the

*We have been furnished statements of operating results of the debtor through November, 1942, which show for that part of the year income available for fixed charges of $10,309,517.18.

[38] Cf. Florida East Coast Ry. Co. Reorganization, Supplemental Report, August 10, 1942, 252 I. C. C. 731, 733:

"In the report of April 6, 1942, division 4 recognized the fact that 1941

Commission plan filed in the court on December 8, 1939, it was suggested that "any estimate of railroad earnings made prior to the development of war conditions must be revised." The court after considering all of the objections offered, but without specifically discussing the changed conditions, approved the plan on August 15, 1940. 34 F. Supp. 493, 504. The Commission's forecast was made with knowledge and not in disregard of past fluctuations of income, in war and in peace. On the showing as to changed conditions made before the District Court, there was no basis for a disapproval of the Commission plan as unfair to the junior equities. The further evidence of increased earnings, placed in the record by the stipulations, does not lead us to reject the Commission's plan.

Effective Date of Plan. January 1, 1939, was chosen as the effective date of the plan. The debtor objects to this on the ground that subsection (1) fixes the date of filing the petition as the date for the plan.[39] The practical result of the debtor's argument is to make the interest rate of the new securities applicable from August 2, 1935, instead of from January 1, 1939. As the new securities bear lower interest rates than the contract securities, a savings to the estate would accrue.[40] But we are of the opinion that the provisions of subsection (b) are sufficiently broad to empower the Commission to select the date for the institution of the reorganization. Cf. *Group of Industrial Investors* v. *C. M. St. P.*

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earnings were influenced by the extraordinary conditions existing as the result of the war and, in the report, stated fully all considerations leading to its conclusions as to justifiable amounts of capitalization and of new general-mortgage bonds. Under present conditions, the fact that the year 1942 gives promise of producing even larger earnings than 1941 affords too uncertain and precarious a basis to justify the increases sought."

Cf., also, In re Alabama, Tennessee and Northern R. Corporation, 47 F. Supp. 694, 708; Akron, Canton & Youngstown Ry. Co. v. Hagenbuch, 128 F. 2d 932, 939; Guaranty Trust Co. v. The Minneapolis & St. Louis R. R. (D. C. Minn.), September 10, 1942; Order No. 968, — F. Supp. —, memorandum, page 13263.

[39] Section 77(1)

"In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

[40] No contention is made that fully secured claims do not bear contract interest to the date of reorganization, whenever it may be. Ticonic Bank v. Sprague, 303 U. S. 406.

& P. R. R. Co., Nos. 11-19, 32, 1942 Term, decided this day, slip opinion p. 14.

Costs. The Institutional Bondholders Committee in No. 7 and the Trustees of the First Mortgage in No. 8 call our attention to the provision in the decree in the Circuit Court of Appeals for costs against appellees there and suggest that costs should be assessed directly against the estate of the debtor in proceedings under section 77. Our reversal of the decree leaves the appellees below free of this provision of the decree and requires us to assess costs on the review. We see also no reason why costs should not be assessed against the losing parties on this review of the action of the District Court and it will be so ordered. This assessment is without prejudice to a motion for allowance for disbursements by respondents in accordance with subsection (c)(12).[41]

Other minor objections to the plan as approved by the District Court are advanced but we do not consider them as of sufficient weight to require comment.

From the foregoing it follows that the judgment of the Circuit Court of Appeals should be reversed and that of the District Court affirmed.

It is so ordered.

Mr. Justice FRANKFURTER agrees with this opinion barring only the views expressed regarding the respective functions of the Interstate Commerce Commission and the District judge, under Section 77 of the Bankruptcy Act.

Mr. Justice JACKSON and Mr. Justice RUTLEDGE took no part in the consideration or decision of this case.

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[41] Cf. Reconstruction Finance Corporation v. Bankers Trust Co., Nos. 387 and 388, October Term 1942, decided February 8, 1943.

SUPREME COURT OF THE UNITED STATES.

Nos. 7, 8, 20, 33 and 61.—October Term, 1942.

Frederick H. Ecker, John W. Stedman, and Reeve Schley, constituting Institutional Bondholders Committee, Petitioners,
vs.
Western Pacific Railroad Corporation, A. C. James Co., The Railroad Credit Corporation, et al.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[March 15, 1943.]

Mr. Justice Roberts.

I am in agreement with much that is said in the opinion, but I desire separately to state my views as to the respective roles assigned to the Interstate Commerce Commission and to the District Court in the reorganization process.

Section 77 was adopted in the exercise of the power conferred by the Constitution upon Congress to establish uniform laws on the subject of bankruptcies throughout the United States. The proceeding is, from its initiation, one in bankruptcy. The legislation constitutes the Interstate Commerce Commission an arm of the court and clothes the Commission with certain functions as such. No question is made as to the authority of Congress thus to divide responsibilities between the court and the Commission in the formulation of a plan of reorganization. Section 77 is the guide to decision concerning the respective duties of the court and the Commission. The statutory provisions quoted in Note 7 of the majority opinion seem to me clearly to define the boundaries of the powers conferred.

Certain requisites and certain permissible features of the plan, for the formulation of which the Commission has sole responsibility, are prescribed or permitted. Within very broad limits the Commission is given discretion in the application of these in formulating a plan. [Subsection (b).] When the plan is certified to the judge his function is, as the court holds, merely to see that the limits set in subsection (b) are not transgressed; that the Com-

mission has observed the standards and limits thereby set. See Subsection (e) which directs that the judge shall approve the plan if satisfied that it complies with the provisions of subsection (b).

Other functions are reposed solely in the Commission. It is to determine whether the plan "will be compatible with the public interest". [Subsection (d).] I need not discuss the purport of this direction, which obviously relates, in the main, to the proposed corporate and capital structure of the reorganized company. That structure must be such that the rehabilitated enterprise may have a reasonable prospect of satisfactory public service. The statute will be searched in vain for any mandate to the court to review or overturn the Commission's judgment in this respect; and I agree that the District Court properly held that the protection of the public interest was so far committed to the Commission that, except for the most egregious disregard of relevant considerations, the judge should hold himself bound by the Commission's appraisal of the demands of that interest.

Another vital step in formulating any plan is committed to the judgment of the Commission. This is valuation of property. Subsection (e) states that, if it shall be necessary to determine the value of any property for any purpose under the Act, the Commission shall determine such value and certify the same to the court in its report. It seems clear, as the opinion states, that the court cannot reject the plan for any mere asserted error in valuation. Its power is limited to an examination of the question whether the Commission acted wholly without evidence, arbitrarily, or in disregard of recognized criteria.[1]

In equity reorganizations prior to the passage of § 77 the phrase "fair and equitable" had come to have a recognized content. It meant that, in allotting interests in the reorganized company, the priorities existing between lienors and stockholders of the debtor must be substantially preserved. No reorganization could be fair and equitable if, in the new capital structure, junior interests were allowed to participate at the expense of those who had had a senior position in the old.[2]

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[1] I believe this is so as to the valuation of all the assets and as to valuations of property subject to liens or available for the claims of classes of creditors or stockholders. See Subsection (e) par. 2.

[2] Northern Pacific Ry. Co. *v.* Boyd, 228 U. S. 482; Case *v.* Los Angeles Lumber Co., 308 U. S. 106; Consolidated Rock Products Co. *v.* Du Bois, 312 U. S. 510.

Section 77 sought to preserve and enforce this rule of law. By subsection (d) the Commission is charged with seeing that a proposed plan meets the requirements of subsection (e) and, by subsection (e) it is provided that, on certification of a plan to the court, all parties may file detailed and specific objections to the plan and their claims for equitable treatment. The judge is to hold a hearing on such objections "and such claims for equitable treatment". Thus the statute provides for the framing in court of sharp and specific issues directed to the plan's compliance with the rule governing allocation, and this fact is emphasized by the leave granted the parties to produce in court additional evidence. After the direction that the judge shall approve the plan "if satisfied" it complies with subsection (b), (which involves only a determination, as above indicated, whether the Commission, in setting up the plan, has respected the limits set by Congress in subsection (b)), subsection (e) goes on to deal with the judge's action on the objections of the parties and their claims for equitable treatment. It provides that he must be satisfied that the plan "is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders."

I read this language as placing upon the court a duty quite distinct from any imposed upon it in connection with the general features of the plan or in connection with any findings of the Commission with respect to the value of property. The statute contemplates that the judge shall not only examine the findings of the Commission with respect to the fair equivalent of what is granted to mortgagees or stockholders compared to the interest in the old company that they are to surrender, and the Commission's reasons for its action, but also hear evidence by which he may be more fully informed as to the equity and fairness, as those terms have specific legal connotation, of rights accorded under the plan in relation to those theretofore enjoyed. In my view, Congress intended that the judge should satisfy himself, as in the old equity proceedings he was bound to do, that the relation between the various classes of investors is substantially maintained in the reorganization.

In order to discharge this judicial duty the court obviously may have to pass upon questions of law. In the present case, a deci-

sion as to the priority and extent of the respective mortgage liens is a legal prerequisite to an adjudication of the issue whether different classes of mortgage bondholders received fair and equitable treatment in the apportionment of new securities. I agree with the conclusions of the court on the question of law thus presented. It happens that the parties in interest do not challenge the fairness of the allocation as between them, if the Commission was right in its tentative conclusion concerning the coverage of the first mortgage and that of the general and refunding mortgage. In this case, then, the function of the court was fully performed once it had decided that question of law. In other cases, where the issue of fairness and equity depends upon the facts disclosed, I think it is the duty of the court to go farther and examine the plan sufficiently to satisfy itself that the rule of absolute priority announced in the *Boyd* case and in the *Los Angeles* and *Rock Products* cases has not been violated. In performing this duty the court should accord great weight to the Commission's action. It should require the objector to show that the Commission has failed to respect the doctrine. But it should not accord finality to the Commission's action if there be any evidence to support it. I believe the court is charged by subsection (e) with the duty of determining that, in the allocation of securities in the reorganized company, the Commission has a substantial foundation in the facts for the allocation of securities required by the plan it approves.

I concur in the judgment of the court.

Mr. Justice FRANKFURTER joins in this opinion.